S. Hrg. 99-846

THE FINANCIAL INSTITUTIONS EMERGENCY ACQUISITIONS AMENDMENTS OF 1986

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 2372

TO PRESERVE THE AUTHORITY OF THE FEDERAL BANKING SUPERVISORY AGENCIES TO ARRANGE INTERSTATE ACQUISITIONS AND MERGERS FOR FAILED AND FAILING BANKS, AND FOR OTHER PURPOSES

MAY 13 AND 14, 1986

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THE FINANCIAL INSTITUTIONS EMERGENCY ACQUISITIONS AMENDMENTS OF 1986

TUESDAY, MAY 13, 1986

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Gramm, Proxmire, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order.

Today we will hear testimony on S. 2372, the Financial Institutions Emergency Acquisitions Amendments.

I introduced that legislation on April 24, 1986, at the request of the bank regulators. It amends title I of the Garn-St Germain Act in three material ways to increase flexibility for the Federal bank supervisors in minimizing the adverse effects of failing banks.

First, the bill would lower threshold size from $500 to $250 million for an institution which could be sold across State lines.

Second, it expands the approval of interstate acquisition from only closed banks to banks which the regulator determines are in danger of closing.

Finally, it gives the Federal bank regulators authority to resolve problems in meeting the claims of banks in multibank holding company States.

The regulators bill which we are discussing today will be included in a comprehensive legislative package I intend to introduce in the near future. Legislative language to recapitalize FSLIC will be sent to Congress later this week. That proposal will also be included, as well as other deposit insurance reforms suggestions, in an omnibus bill.

As I've said, many of the items in S. 2851 will likewise be included in such a comprehensive effort designed to address the many changes that have occurred and are continuing to take place in the financial services arena.

This morning we will hear from Federal Reserve Chairman Paul Volcker, Comptroller of the Currency Robert Clarke, and William Seidman, Chairman of the FDIC. Tomorrow at 11 a.m., we will allow various trade groups, including the ABA, the IBAA, the

ABAC, and the CSBS, to voice their interest in and concerns with S. 2372.

Senator Proxmire.

[Copy of proposed bill S. 2372 follows:]

II

99TH CONGRESS
2D SESSION

S. 2372

To preserve the authority of the Federal banking supervisory agencies to arrange interstate acquisitions and mergers for failed and failing banks, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 24 (legislative day, APRIL 21), 1986

Mr. GARN (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To preserve the authority of the Federal banking supervisory agencies to arrange interstate acquisitions and mergers for failed and failing banks, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Financial Institutions Emergency Acquisitions Amendments of 1986".

ASSISTED EXTRAORDINARY ACQUISITIONS

SEC. 2. Section 13(f) of the Federal Deposit Insurance Act (12 U.S.C. 1823(f)) is amended—

(1) by amending paragraph (1) to read as follows:

"(1)(A) Whenever the appropriate Federal banking agency is informed that an out-of-State bank or holding company is considering acquiring, directly or indirectly, an insured bank with total assets of $250,000,000 or more that is in danger of closing, such agency shall (A) notify the Corporation of such, (B) consult with the Corporation before taking any action with respect to any such acquisition, and (C) provide the Corporation with notice of any final action taken.

"(B) Except as provided in paragraph (9), the provisions of this subsection shall be used exclusively in connection with any acquisition by or merger with an out-of-State bank or holding company with respect to which the Corporation provides assistance under its powers in subsection (c) and shall not be applicable if the Corporation does not provide such assistance. Nothing contained in this subsection shall be construed to limit the Corporation's powers in subsection (c) to assist a transaction.".

(2) by striking out "$500,000,000" in subparagraph (2)(A) and inserting in lieu thereof "$250,000,000".

(3) by amending subparagraph (3) to read as follows:

"(3)(A)(i) Whenever the appropriate Federal or State chartering authority has certified in writing that an insured bank with total assets of $250,000,000 or more (as determined from its most recent report of condition) is in danger of closing, the insured bank may merge with or its assets may be purchased by and its liabilities assumed by another depository institution, including an insured depository institution located in the State where the insured bank is chartered but established by an out-of-State bank or holding company, or its shares may be acquired by an out-of-State bank or holding company.

"(ii) Whenever the appropriate Federal or State chartering authority has certified in writing that one or more insured bank subsidiaries of a holding company are in danger of closing and such bank or banks hold aggregate assets equal to $250,000,000 or more (as determined from their most recent reports of condition) and such bank or banks represent 33 per centum or more of the total assets of all insured bank subsidiaries (as determined from their most recent reports of condition) of such holding company, an out-of-State bank or holding company may (a) purchase the shares of or otherwise acquire the holding company that controls such bank or banks and all of such holding company's subsidiary banks or (b) purchase the shares or otherwise acquire any such bank or banks in danger of closing and/or establish one or more newly chartered banks located in the State where such banks in danger of closing are chartered for the purpose of merging with or purchasing the assets and assuming the liabilities of such banks, provided the aggregate total assets of such banks that are acquired equal $250,000,000 or more. Any out-of-State bank or holding company which, pursuant to clause (b), purchases shares of, or establishes a newly chartered bank for the purpose of merging with or acquiring the assets and assuming the liabilities of, such bank or banks in danger of closing may purchase the shares of or otherwise acquire any bank which is affiliated with such bank or banks.

"(iii) The Corporation may assist a merger or acquisition permitted under subparagraph (A) only where the board of directors or trustees of the insured bank has requested in writing that the Corporation assist a merger or a purchase.

"(B) Whenever the Corporation provides assistance, directly or indirectly, under the authority of subsection (c), to an insured bank and such bank was eligible at the time such assistance was given to be acquired by an out-of-State bank or holding company, pursuant to subparagraph (A), the bank shall remain eligible to be acquired, to the same extent that it was eligible when assistance was granted, by an out-of-State bank or holding company so long as the Corporation's assistance remains outstanding. If, at the time such assistance was granted to an insured bank or to affiliated insured banks, such bank's or banks' parent holding company or other affiliated banks were eligible also to be acquired by an out-of-State bank or holding company, pursuant to subparagraph (A)(ii), they shall remain eligible for such acquisition to the same extent as they were when the assistance was granted, so long as such assistance remains outstanding.

"(C) Where otherwise lawfully required, a transaction under this paragraph (3) must be approved by the primary Federal or State supervisor of all parties thereto.

"(D)(i) Before assisting a merger or acquisition permitted under subparagraph (A) or taking final action under subparagraph (B), the Corporation shall consult the State bank supervisor of the State in which the bank in danger of closing is chartered.

"(ii) The State bank supervisor shall be given a reasonable opportunity, and in no event less than forty-eight hours, to object to the use of the provisions of this paragraph.

"(iii) If the State supervisor objects during such period, the Corporation may use the authority of this paragraph only by a unanimous vote of the Board of Directors. The Board of Directors shall provide to the State supervisor, as soon as practicable, a written certification of its determination.".

(4) by redesignating subparagraphs (i) through (iii) of paragraph (4) as subparagraphs (A) through (C), respectively.

(5) by amending newly redesignated subparagraph (4)(A) to read as follows:

"(A) Neither section 3(d) of the Bank Holding Company Act of 1956, section 408(e)(3) of the National Housing Act, any provision of State law, nor the constitution of any State, shall bar approval, consummation or retention of an acquisition authorized under paragraph (2) or (3), except that an out-of-State bank may make such an acquisition only if such ownership is otherwise specifically authorized.".

(6) by adding new subparagraphs (D) and (E) to paragraph (4) as follows:

"(D) An out-of-State bank holding company that acquires, directly or indirectly, a bank under paragraph (2) or (3) shall thereafter be entitled to acquire additional banks located in the three largest metropolitan or consolidated metropolitan statistical areas or cities in any State in which the acquired bank is located to the same extent as a bank holding company that is principally located (as such term is defined in section 3(d) of the Bank Holding Company Act of 1956) in such State.

"(E) A holding company which, directly, or indirectly, acquires control of one or more banks or a holding company under paragraph (2) or (3) shall not, by reason of such acquisition or expansion, be required as the result of the law of any State to divest any other bank or banks or be prevented from acquiring, directly or indirectly, any other banks or holding company.".

(7) by striking "to permit" in paragraph (5).

(8) by striking out "closed" the second time it appears and "bank" the sixth time it appears in subparagraph (6)(A).

(9) by redesignating subparagraphs (B) and (C) in paragraph (8) as subparagraphs (D) and (E), respectively, and by inserting after subparagraph (A) the following new subparagraphs:

"(B) a bank is 'in danger of closing' if:

"(i) the bank is not likely to be able to meet the demands of its depositors or pay its obligations in the normal course and there is no reasonable prospect for it to do so without Federal assistance; or

"(ii) the bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital and there is no reasonable prospect for replenishment of the bank's capital without Federal assistance; or

"(iii) other grounds exist or are likely to exist under applicable State law for closing the bank; and

"(C) banks are 'affiliated' if each is a subsidiary (as defined in section 2(d) of the Bank Holding Company Act of 1956) of the same holding company; and".

(10) by adding a new paragraph (9) to read as follows:

"(9) Nothing in this subsection shall prevent the Corporation, in its sole discretion, from assisting, directly or indirectly, the acquisition of an open or closed insured bank by an out-of-State bank or holding company where such an acquisition is otherwise authorized under applicable State law.".

(11) by adding a new paragraph (10) to read as follows:

"(10) In any transaction authorized under this subsection, no assistance by the Corporation shall be provided to a subsidiary of a holding company that is not an insured bank.".

UNASSISTED EXTRAORDINARY ACQUISITIONS

SEC. 3. Section 3(d) of the Bank Holding Company Act (12 U.S.C. 1842(d)) is amended by designating the first paragraph thereof as paragraph (1) and inserting at the end thereof the following new paragraphs:

"(2) Notwithstanding the provisions of paragraph (1) of this subsection or any provision of State law or the constitution of any State—

"(A) a bank holding company may acquire and retain the shares or assets of—

"(i) a bank located in another state if such bank has total assets of $250,000,000 or more and is in danger of closing; or "(ii) two or more affiliated banks in danger of closing that together hold assets that total $250,000,000 or more and that represent 33 per centum of the total assets of all affiliated banks;

"(B) a bank holding company that acquires a bank or banks in danger of closing under subparagraph (A) may acquire a bank holding company that controls such bank or banks and/or may acquire the assets or shares of any bank affiliated with such bank or banks, provided in either case that the total assets of such bank or banks in danger of closing represent at least 33 per centum of the total assets of all affiliated banks;

"(C) a bank holding company that acquires the assets or shares of a bank in danger of closing under subparagraph (A) or (B) may acquire additional banks located in the three largest metropolitan or consolidated metropolitan statistical areas or cities in any State in which a bank acquired pursuant to this paragraph is located to the same extent as a bank holding company that is principally located (as defined in paragraph (1) hereof) in such State.

"(D) a bank holding company that acquires and retains control of one or more banks pursuant to this paragraph shall not, by reason of such acquisition or retention, be required to divest any other bank or banks or be prevented from acquiring any other banks.

"(3) A bank holding company may not acquire the shares or assets of a bank or bank holding company under paragraph (2)(A) or (B) unless the acquisition has been approved by the board of directors of such bank or of a bank holding company that controls such bank.

"(4)(A) A bank is in danger of closing if the appropriate Federal or State chartering authority certifies in writing that—

"(i) the bank is not likely to be able to meet the demands of its depositors or pay its obligations in the normal course and there is no reasonable prospect for it to do so without Federal assistance; or

"(ii) the bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital and there is no reasonable prospect for replenishment of the bank's capital without Federal assistance; or

"(iii) other grounds exist or are likely to exist under applicable State law for closing the bank.

"(B) A bank is affiliated with another bank if each is a subsidiary of the same bank holding company.

"(C) The assets of a bank shall be determined on the basis of its most recent report of condition.

"(5)(A) No bank in danger of closing or bank holding company that controls such bank shall enter into any discussions relating to the acquisition of such bank under paragraph (2) unless—

"(i) the State bank supervisor for each State in which such bank or its affiliated banks is located has been notified of such proposed discussions, and

"(ii) such bank or bank holding company has attempted to arrange an acquisition that does not require assistance under section 13(c) of the Federal Deposit Insurance Act or use of the interstate provisions of paragraph (2). An application submitted under paragraph (2)(A) or (B) must describe efforts made by such bank or bank holding company to satisfy this requirement and the reasons for the rejection of any proposals submitted.

"(B) Before approving an application pursuant to paragraph (2) involving a bank in danger of closing or its affiliated banks, the Board shall consult the State bank supervisor of the State or States in which the bank or banks are located.

"(C) The State bank supervisor or supervisors shall be given a reasonable opportunity, and in no event less than forty-eight hours, to object to approval of the application.

"(D) Except as provided in subparagraph (E), the Board shall not approve the application if, during the notice period provided in subparagraph (C), such State bank supervisor certifies to the Board that—

"(i) a person or persons have, prior to the notice period in subparagraph (C), offered or attempted to offer to acquire each of the banks in danger of closing in a transaction that does not require assistance under section 13(c) of the Federal Deposit Insurance Act or use of the interstate provisions of paragraph (2), and

"(ii) such person or persons, in the judgment of such State bank supervisor, are likely to be able to secure all regulatory approvals necessary to consummate such acquisition promptly, and to comply with all applicable financial and managerial and other regulatory requirements, including recapitalizing all such banks in danger of closing without impairing the financial resources of the acquiring person or persons.

"(E) The Board may approve the application if the Board determines that the person or persons certified by the State bank supervisor under subparagraph (D) do not have the financial resources necessary to obtain regulatory approval to acquire such bank, including the resources to recapitalize all such banks in danger of closing without impairing the financial resources of the acquiring persons or persons, or that such person or persons do not meet other applicable regulatory requirements.

"(6) If the Board has received a certification from the appropriate Federal or State chartering authority pursuant to paragraph (2) or section 13(f) of the Federal Deposit Insurance Act that a bank is in danger of closing, the Board may dispense with the notice and hearing requirements of section 3(b) of this Act with respect to any application received to acquire such bank or its affilitated banks and may reduce the postapproval waiting period of section 11 of this Act to five days or, if the Board finds that immediate action is necessary to prevent the probable failure of any such banks, eliminate such period.".

WAIVER OF NOTICE REQUIREMENTS

SEC. 4. Section 4(c)(8) of the Bank Holding Company Act (12 U.S.C. 1843(c)(8)) is amended by adding a new sentence to the end thereof to read as follows:

"In the event an application is filed under this paragraph in connection with an application by a bank holding company to acquire control of a bank in danger of closing or its affiliated banks pursuant to section 3(d)(2) of this Act or section 13(f) of the Federal Deposit Insurance Act, the Board may dispense with the notice and hearing requirement of this paragraph and the Board may approve or deny the application under this paragraph without notice or hearing.".

SUNSET PROVISIONS

SEC. 5. (a) Section 141(a) of the Garn-St Germain Depository Institutions Act of 1982 (12 U.S.C. 1464 note) is amended by striking out "April 15, 1986" and inserting in lieu thereof "April 15, 1991".

(b) Effective upon April 15, 1991, the provisions of law amended by this Act shall be amended to read as they would without such amendments.

(c) The repeal or termination by this section 5 of any amendment made by this Act shall have no effect on any action taken or authorized while such amendment was in effect.

○

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Mr. Chairman, today the committee begins hearings on S. 2372, the Financial Institutions Emergency Acquisitions Amendments of 1986. This legislation was requested by the three bank regulatory agencies to allow officials from these agencies to override the law and Constitution of all 50 States by selling failing banks across State lines, regardless of State law.

It strikes a major blow against the right of States to determine their own banking structure. In so doing, it threatens to undermine our decentralized banking system and local control over credits, which has been the keystone of our banking policy for over two centuries.

Mr. Chairman, the bank regulators have made no convincing case, either publicly or privately, for this sweeping increase of their power to abrogate State law.

I think this committee should be extremely cautious in this legislation. We should not be stampeded into hasty or precipitous action which could destroy the essence of our decentralized banking system.

Why the big rush for a Washington solution to a local problem? The States themselves have ample authority to amend their laws to permit interstate acquisitions, if they feel there is a real emergency that threatens to disrupt vital banking services within their borders.

States have acted in a timely fashion with respect to past emergencies. It is the height of arrogance to assert that we in Washington know what is good for the States better than the States themselves.

If the committee is included to act, I believe substantial safeguards are needed to prevent the abuse of this sweeping authority. The legislation should also be combined with other pressing issues that have been on our agenda for the last several years. In particular, if we are to give the regulators new power to abrogate State law on bank acquisitions, we also need to close the nonbank bank loophole.

What large money center bank would be interested in buying a failing bank in another State, if it could enter that State by establishing a nonbank bank?

So Mr. Chairman, I would be pleased to work with you and other members on a comprehensive banking bill that will address all of the unsolved issues before the committee. This is no time for piecemeal solutions.

The CHAIRMAN. I think Senator Proxmire has some questions about your proposals, gentlemen. [Laughter.]

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. I want to extend the committee's gratitude to this morning's distinguished witnesses who have come to apprise us of the grave conditions confronting certain banking institutions. The legislation that we will address this morning, S. 2372, the Financial Institutions Emergency Acquisitions Amendments, has been designed with much input from the regulators who are here to testify today. We have been informed by these gentlemen that in order to avert a potential crisis condition in certain areas of the country, S. 2372 must be passed and passed quickly.

If crisis avoidance is the compelling reason for enactment of this legislation, then I hope that we will be presented with some facts regarding the nature and extent of the problem that the bill is designed to remedy.

The legislation has beneficial aspects, foremost among them is that it would allow for the first time a failing bank or bank holding company to be appointed through an interstate or intrastate, an assisted or unassisted acquisition. This provision will permit the bank regulators to take affirmative steps to save a failing institution before an institution has actually failed.

At present, the regulators are, in essence, only allowed to operate on the patient after it has died on the operating table. So it is not surprising that the success rate of such operations has been zero. The ability to address failing as well as failed institutions has met with success in dealing with failing savings and loans. Hopefully, S. 2372 will permit the regulators to achieve similar results with regards to banks and bank holding companies.

To the extent that S. 2372 promotes interstate banking, I consider it an absolute necessity, even though I would prefer not to encourage geographical deregulation through disaster; however, my ardor for S. 2372 is cooled by those provisions that would discourage interstate banking.

Hopefully, the witnesses can offer some policy reasons for permitting a bank holding company to cross State lines and then limiting its ability to expand within the State of the new acquisition. I don't understand that.

I think that is political expedience. I wonder what justification exists that would restrict the acquiring institution to locating in three additional standard metropolitan statistical areas, once that institution has burdened itself and simultaneously relieved the FDIC of a potential financial burden through the acquisition of an ailing bank or bank holding company.

If you want to play games like that, maybe Senator Proxmire is right.

I also have some questions regarding the extent to which an acquiring institution can expand in a branch banking State.

I look forward to your testimony, but I must confess my beliefs that this legislative proposal was put together with a little political bailing wire. You're copping out. Thank you, Mr. Chairman.

The **Chairman**. Senator Hecht.

OPENING REMARKS OF SENATOR HECHT

Senator **Hecht**. Thank you, Mr. Chairman. Sounds like a lively debate is soon going to begin. I will be anxious to hear your reasons why. How I feel about it, I am not sure at the moment, but I do want to commend the three of you for bringing this to our attention. It shows the Government is now responsive to the market conditions, and you are trying to deal with a crisis before it happens.

For this, I think you should be commended. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Hecht.

Senator Mattingly.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. I'm pleased we are having these hearings on S. 2372, the Financial Institutions Emergency Acquisitions Amendments. While the regulators contend we are faced with a difficult situation in some part of the banking community, and thus a congressional response is needed, and needed quickly, I think it's important that we proceed cautiously.

This bill is no technical, mundane recommendation. Instead, it has the potential of giving the regulators the authority to implement nationwide interstate banking, a move the Senate overwhelmingly rejected in 1984 on more than one occasion. In other words, S. 2372 runs the risk of overturning years of expressed congressional intent by regulatory fiat. I think every word, every provision of the bill needs to be explained and justified by today's witnesses.

Interstate banking has been a controversial and sensitive subject matter for many years. We should not reverse years of sound, rationale public policy lightly, and without thoughtful deliberation.

Thank you Mr. Chairman.

The CHAIRMAN. Chairman Volcker.

STATEMENT OF PAUL VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, I have a statement, but I will just read parts of it, with your permission. I think you are already familiar with the basic provisions of the bill.

BETTER TOOLS REQUIRED FOR RESCUE OF FAILING BANKS

We come before you, I think, with common judgment that the tools we now have for dealing with emergency situations involving failed or failing banks, including those within sizable bank holding companies, are not fully adequate. That judgment was reached in light of strains and pressures involving banks in entire States or regions of the country, that, as a result of the turmoil in energy and agricultural markets, face unusually severe economic conditions. Specifically, we are concerned that the States where major banking organizations take the form of multibank holding companies should have a tool to deal with banks within that holding company structure, to deal with a coherent whole, rather than piece by piece.

We also believe that in some situations, we can act more expeditiously with less risk to confidence and to other banks and with less cost to the FDIC insurance fund, if mergers with out-of-State institutions can be arranged before a bank actually fails or requires FDIC assistance.

To these ends, as you indicated, Mr. Chairman, we would allow the interstate acquisition of a multibank holding company or some or all of the banks within a holding company, when a significant portion of the banking assets of a holding company are impaired. We would reduce the bank asset size criterion for such interstate acquisitions from the present $500 million to $250 million, and we would permit acquisition of failing, as well as failed banks.

As members of this committee are aware, a series of developments over this decade have adversely impacted banks and led to an unusual number of failures and more generalized strains. Disinflation, strong competition, and rapid changes in technology and market values have all played a part.

Taken as a whole, I think the banking system has responded constructively and resiliently to these pressures. There is, indeed, highly encouraging evidence that the system as a whole is now gaining strength. Specifically, for most banks, capital ratios have improved, earnings have increased, and nonperforming assets have been reduced. But in certain areas of the country, particularly where the economy is heavily dependent on agriculture and energy, these strains have been particularly great, and they have been recently aggravated by the sharp declines in energy, agricultural, and land prices. It is mainly in those areas where we face a compelling need to be in a position to deal with problem situations in a manner that will protect rather than undermine the strength and stability of the whole, including the vast majority of institutions that are fully capable of dealing with their own problems, so long as general confidence is maintained.

Fortunately, the banks, large and small, that have served now-troubled energy and farming business have typically been in a relatively strong position. They have generally been characterized by historically high capital ratios, good earnings, and ample liquidity. The fact that they have been able to draw on those strengths has provided a strong first line of defense in dealing with the present pressures. Ordinarily, that should be adequate.

Supplementing their natural strength, the Federal Reserve is, of course, fully prepared to provide assistance as part of the process of making necessary adjustments to pressures through its discount window on liquidity and changes in deposit flows. The availability of that kind of normal and appropriate assistance by the central bank, backstopping the resources and resourcefulness of the banking organizations themselves, should in itself enable solvent institutions to adjust to the situation.

But I must emphasize there is remaining potential danger to the stability of banking in these heavily impacted areas and, therefore, to the entire economies of some States or regions.

The failure of a few important institutions—unless handled expeditiously and effectively—could raise unwarranted concerns about other basically sound banks and lead to a contagious and spreading loss of confidence. It is that contingency that we want to deal with and toward which the proposed legislation is directed. The powers sought are precautionary. Perhaps they will, in the end, not have to be used, and I hope not. But it surely would be imprudent to rely on that hope. Recent earnings reports and other difficulties at a few institutions point to the danger. A prompt congressional response will, in itself, provide a strong message of reassurance.

PROPER SAFEGUARDS IN S. 2372

Mr. Chairman, as I review the contents of these proposals, they are directed toward the question of how we balance the kinds of concerns that Senator Proxmire raised. This is not a new initiative, in the sense that we already have emergency legislation of this sort, of this general character. It is a new initiative, but it is not a new principle. What we would be doing is extending what already exists with respect to commercial banks. It already exists with respect to thrifts, in general, mutual savings banks and savings and loans. In some ways, the legislation that we are proposing is less sweeping than what already exists with respect to the thrift industry. And I might just list some of the factors. There may be some difference of opinion between Senator D'Amato and Senator Proxmire on this question, but let me list the things that we put in the bill to minimize its impact on the rights of States to establish their own banking structures.

Specifically, interstate acquisitions could only be made of banks or units in a holding company system, when their operation as an independent going concern is no longer feasible. Only the chartering authorities, State or Federal, as the case may be, could initiate the process of interstate acquisition before determining the bank is failed or failing.

A minimum size requirement has been maintained, although at a lower level. An out-of-State acquirer of a bank or a bank holding company would have its subsequent expansion rights limited to the three largest metropolitan areas and cities within a State. Perhaps most importantly, consultation with the relevant State bank supervisor will be required as to the possibility of an in-State solution. In the case of a failing or failed institution, where the FDIC provides assistance, bidding priorities in present law favoring an in-State solution are retained and the objection by a State supervisor could be overridden only by a unanimous vote of the FDIC board.

In the case of a failing institution where no FDIC assistance is provided, no interstate acquisition could proceed if the State supervisor certifies there is a qualified in-State acquirer, unless the Federal Reserve Board determines that the proposed in-State buyer does not, in fact, have adequate financial resources.

Finally, there is the sunset provision where the authority provided would end after 5 years.

We believe these safeguards are reasonable and workable, balancing the legitimate concerns of the States and competing banks with the broader interest in effective action to deal with emergency situations. They build upon concepts and tests in existing law, either for banks or thrifts. I am not aware of serious concerns that those existing authorities have been abused.

So far as the failing bank test is concerned, the intent is plainly to deal only with institutions that, in terms of strong liquidity pressures or impaired capital, would otherwise require large and prolonged official assistance, if they are able to survive at all with ancillary risks to the FDIC fund. In effect, the only alternative to merger would be to make them wards of the Government for an indefinite period.

If such institutions were permitted actually to fail, it is widely accepted they would be eligible for interstate acquisition. If that premise is accepted, the new provision for failing banks certainly appears reasonable, as a matter of further protecting the FDIC fund and the stability of other banks that could be infected by a confidence crisis. Such a provision has already been adopted for thrifts. Strong preference would be provided for an in-State solution, if, in fact, such a solution exists. In fact, that protection would be stronger if, under current law, the banks failed and FDIC funds were more directly at risk.

ROLE OF STATE SUPERVISORS

In all cases of failing institutions, the board of directors or the stockholders of the institution itself would have to agree to a proposed merger. Some have questioned whether this might lead to a preference for an out-of-State partner willing to pay a higher price. That is one reason that the relevant State supervisor has been provided an effective veto power, so long as there is, in fact, a feasible in-State partner ready, willing, and able to provide the necessary capital and other support.

Other questions have arisen with respect to the necessity to deal with the units of a multibank holding company as a whole. In some instances, dismemberment of a holding company may, indeed, be possible. But that will not always or even typically be consistent with achieving the purposes of the legislation—speedy and orderly dispostion of severe problems in a manner consistent with the stability of the banking system over an entire State or region. Specifically, in cases where the failed or failed units within a holding company are key units of the system, piece-by-piece disposition would imply that sister banks are cut adrift without the operating, accounting, and product delivery systems often centered in lead banks or the holding company itself. Units that might have been both solvent and liquid within the holding company structure would find their viability undermined, and they would have to maintain themselves as independent units, units that would inevitably be tinged with their past association with a failed holding company organization.

Nor are individual units of a holding company likely to be attracted to potential out-of-State acquirers. The associated uncertainties and potential disruptions are precisely what the bill is designed to avoid.

In conclusion, Mr. Chairman, speaking from the perspective of the Federal Reserve, we do feel that this is a situation that requires precautionary action. I would like to see this legislation adopted, just as rapidly as you could arrange it. It is the kind of thing where acting in advance of the event can save us a great many difficulties that might otherwise arise, if we were not in a position to deal with some of these situations in some States, expeditiously.

I think we have adequate protections in here to deal with the kinds of concerns that Senator Proxmire raised. I do not view it, and I do not believe that analysis will bear out, that this is any sweeping attack on interstate banking. I think the number of cases we are likely to have to use this would be quite limited and would pale into insignificance, so far as interstate banking is concerned, compared to the amount of development we have had at the initiative of the States themselves in recent years.

So I do not think that that issue of interstate banking, given the protections that we have built into this legislation, warrants delay in dealing with this legislative proposal, given the conditions that exist.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

For release on delivery
9:00 a.m. EDT
May 13, 1986

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

May 13, 1986

I appreciate the opportunity to appear before this Committee today to discuss S. 2372, the Financial Institutions Emergency Acquisitions Amendments of 1986. That legislation would make a number of important, but still limited, changes to the emergency provisions of the Garn-St Germain Depository Institutions Deregulation Act of 1982.

For your convenience, I have attached to my statement a short, and I hope readable, explanation of the bill. In this statement, I will focus on the principal issues involved -- the urgent need for action and the means of balancing the effectiveness of the proposed measures with appropriate protection of the interests of individual states.

The federal banking regulators -- the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency -- have reached a common judgment that the tools we have now for dealing with emergency situations involving failed or failing banks, including those within sizable bank holding companies, are not fully adequate. That judgment was reached in the light of strains and pressures involving banks in entire states or regions of the country that, as a result of the turmoil in energy and agricultural markets, face unusually severe economic conditions.

The existing provisions of the Garn-St Germain Act provide for emergency interstate acquisitions of failed banks of $500 million or more. Companion provisions for thrifts are decidedly more liberal both with respect to size and other criteria. Both provisions have been decidedly helpful in dealing with points of strain. But the banking structure and economic conditions in states heavily impacted by energy and agricultural problems strongly indicates that these authorities need to be strengthened to provide further assurance that problems -- actual and potential -- can be dealt with

expeditiously and in a manner that will avoid a potentially contagious and debilitating loss of confidence within a state.

Specifically, we are concerned that in states where major banking organizations take the form of multi-bank holding companies, we have the tools to deal with banks within that holding company structure as a coherent whole rather than piece-by-piece. We also believe that, in some situations, we can act more expeditiously, with less risk to confidence and to other banks and with less cost to the FDIC insurance fund, if mergers with out-of-state institutions can be arranged before a bank actually fails or requires FDIC assistance.

Specifically, our strong recommendation is that the emergency acquisition powers be expanded to:

- allow the interstate acquisition of a multi-bank holding company, or some or all of the banks within a holding company, when a significant portion of the banking assets of a holding company are impaired;

- -- reduce the bank asset size criterion for such interstate acquisitions to $250 million; and
- -- permit acquisition of failing as well as failed banks.

As members of this Committee are aware, a series of developments over this decade have adversely impacted banks and led to an unusual number of failures and more generalized strains. Disinflation, strong competition, and rapid changes in technology and market values have all played a part.

Taken as a whole, the banking system has responded constructively and resiliently to these pressures. There is, indeed, highly encouraging evidence that the system as a whole is now gaining strength. Specifically, for most banks, capital ratios have improved, earnings have increased and nonperforming assets have been reduced.

Nevertheless, in certain areas of the country, particularly where the economy is heavily dependent on agriculture and energy, these strains have been particularly great; and they have been aggravated by the sharp declines in energy, agricultural, and land prices. It is mainly in those areas where we face a compelling need to be in a position to deal with problem situations in a manner that will protect, rather than undermine, the strength and stability of the whole, including the vast majority of institutions that are fully capable of dealing with their own problems so long as general confidence is maintained.

Fortunately, the banks, large and small, that have served now-troubled energy and farming businesses have typically been in a relatively strong position. They have generally been characterized by historically high capital ratios, good earnings and ample liquidity. The fact that they have been able to draw on these strengths has provided a strong first line of defense in dealing with the present pressures. Ordinarily, that should be adequate.

Supplementing their natural strength, the Federal Reserve is, of course, fully prepared to provide assistance as part of the process of making necessary adjustments to pressures through its discount window on liquidity and changes in deposit flows. The availability of that kind of normal and appropriate assistance by the central bank, backstopping the resources and resourcefulness of the banking organizations themselves, should in itself enable solvent institutions to adjust to the situation.

However, there is one remaining potential danger to stability of banking in these heavily impacted areas -- and therefore to the entire economies of some states or regions.

The failure of a few important institutions -- unless handled expeditiously and effectively -- could raise unwarranted concerns about other, basically sound banks, and

lead to a contagious and spreading loss of confidence. It is that contingency that we want to deal with and toward which the proposed legislation is directed. The powers sought are precautionary. Perhaps they will, in the end, not have to be used. I hope not. But it surely would be imprudent to rely on that hope. Recent earnings reports and other difficulties at a few institutions point to the danger. A prompt Congressional response will, in itself, provide a strong message of reassurance.

The case for this legislation is, I believe, widely acknowledged in the states most directly concerned. The debate, as I have observed it, revolves around specific provisions of the proposed legislation that balance the need for effective action against the concerns of states, and banks within a state, that they be able to preserve their ability to determine the future of their state's banking structure.

In striking that public policy balance, Congress has already concluded that interstate banking acquisitions are appropriate in certain emergency situations -- those involving failed banks of $500 million or larger. In addition, separate provisions of present law permit out-of-state acquisitions of both failed and failing mutual savings banks meeting the $500 million minimum asset size requirement and of savings and loan associations without any restrictions as to size. I would also point out that current provisions of law allow the interstate or interindustry acquisitions of thrift institutions "where severe financial conditions exist which threaten the stability of a significant number of insured institutions or of insured institutions possessing significant financial resources."

Those provisions of existing law were adopted because Congress recognized the need for constructive preventative action to assure that a serious particular situation did not

spread and get worse. The same motivation lies behind the present proposal. While the present situation, in our judgment, requires some further extension of authority for interstate bank acquisitions, care has been taken to limit the scope of that authority and to provide a key role for state bank supervisors; in fact, the proposal before you dealing with commercial banks is substantially narrower than the interstate acquisition arrangements for savings and loan associations that are now contained in the Garn-St Germain Act.

Main Provisions of the Legislation

Perhaps the most important change in the proposed legislation would be to permit the federal supervisory authorities to deal with the units of a multi-bank holding company as an integrated whole. This is a recognition of simply reality.

A number of states, including typically those impacted by adverse energy and agricultural developments, have a banking structure built around multi-bank holding companies. Normally, units in those holding companies operate with a large degree of interdependence, under common management. However, the financial condition of different banking units within the holding company may vary substantially.

As things now stand, the law permits us to deal with those units of a holding company bank-by-bank. Some individual banks within the holding company may reach the $500 million size limit specified by the Garn-St Germain legislation, but many units may not, even though the holding company is one of the major institutions in the state. In some cases, none of the units meets the present size test, even if the holding company is far larger. Yet, the failure of one or two important banking units of a holding company would be bound to affect the viability of the whole.

The proposed legislation deals with this situation by enabling the sale of some or all the banks within a holding company, or the holding company itself, to an out-of-state institution when at least one-third of the entire assets of the holding company are in failing units, provided those troubled units collectively reach an aggregate asset size of $250 million.

The second proposal is to modify the asset size limit for an individual bank or for banking units within a holding company by reducing it from $500 million to $250 million. That reduction is in recognition of the fact that deeply troubled institutions of that size, particularly when incorporated in a larger holding company, may not in current circumstances be salable within a state. Indeed, in some cases the holding company involved may be among the largest banking institutions in the state. In other instances, the larger institutions in the state, while able to cope effectively with their own problems, may not be in a position to raise the amount of capital, or to provide the liquidity or management resources necessary for a major acquisition.

The third area of change would be to permit the sale of "failing" -- defined as a bank in danger of closing -- as well as "failed" institutions. The definition of failing is meant to be rigorous -- that is to only include an institution that, while technically still solvent, has no reasonable prospect for either maintaining the liquidity or raising the capital necessary to maintain itself as an independent institution without prolonged federal assistance.

The purpose is straightforward. Such a "failing" institution may be more attractive to a potential buyer than one actually in receivership. The sale might be arranged without disturbance to confidence. There would be no cost, or a lesser cost, to the FDIC.

Limitations on the Use of the Emergency Powers

As I indicated earlier, the debate on the proposed legislation appears to center much less on questions of basic purpose and rationale -- which seems to be broadly accepted -- than on the appropriate specific limitations designed to protect the rights of states. This is a matter to which we have devoted considerable attention. We believe an appropriate balance has been struck consistent with the need for operational effectiveness. That need includes the simple fact that out-of-state purchasers of failed or very troubled institutions will simply not be available, or available only at very heavy cost to the FDIC, unless the acquired banks can be operated profitably in highly competitive markets.

Specifically:

-- Interstate acquisitions could only be made of banks (or units in a holding company system) when their operation as independent going concerns is no longer feasible.

-- Only the chartering authority -- state or federal as the case may be -- could initiate the process of interstate acquisition by determining the bank is failed or failing.

-- A minimum-size requirement has been maintained, although at a lower level.

-- An out-of-state acquirer of a bank or bank holding company would have its subsequent expansion rights limited to the three largest metropolitan areas or cities within a state.

-- In all cases, consultation with the relevant state bank supervisor would be required as to the possibility of an in-state solution. In the case of a failing or failed institution when the FDIC provides assistance, bidding priorities of present law favoring an in-state solution are retained, and an objection by a state supervisor

could be overridden only by a unanimous vote of the FDIC board. In the case of a failing institution where no FDIC assistance is provided, no interstate acquisition could proceed if the supervisor certifies that there is a qualified in-state (or, when regional arrangements exist, regional) acquirer unless the Federal Reserve Board determines that the proposed in-state buyer does not in fact have adequate financial resources.

-- Finally, the authorities provided would end after five years.

We believe these safeguards are reasonable and workable, balancing the legitimate concerns of the states and competing banks with the broader interest in effective action to deal with emergency situations. They build upon concepts and tests in existing law, either for banks or thrifts. I am not aware of serious concerns that those existing authorities have been abused.

So far as the "failing bank" test is concerned, the intent is plainly only to deal with institutions that, in terms of strong liquidity pressures or impaired capital, would otherwise require large and prolonged official assistance if they are able to survive at all, with ancillary risks to the FDIC fund. In effect, the only alternative to merger would be to make them wards of the government for an indefinite period.

If such institutions were permitted actually to fail, it is widely accepted that they would be eligible for interstate acquisition. If that premise is accepted, the new provision for "failing" banks appears certainly reasonable as a matter of further protecting the FDIC fund and the stability of other banks that could be infected by a confidence crisis. Such a provision has already been adopted for thrifts. Strong preference would be provided for an in-state "solution," if in fact such a solution exists -- in fact, that protection would be stronger than if, under current law, the banks failed and FDIC funds were more directly at risk.

In all cases of failing institutions, the board of directors or the stockholders of the institution itself would have to agree to a proposed merger. Some have questioned whether that might lead to a preference for an out-of-state partner willing to pay a higher price. That is one reason that the relevant state supervisor has been provided an effective veto power so long as there is, in fact, a feasible in-state partner ready, willing, and able to provide the necessary capital and other support.

Other questions have arisen with respect to the necessity to deal with the units of a multi-bank holding company as a whole. In some instances, dismemberment of a holding company may indeed be possible. But that will not always, or even typically, be consistent with achieving the purposes of the legislation -- speedy and orderly disposition of severe problems in a manner consistent with the stability of the banking system over an entire state or region.

Specifically, in cases where the failed or failing units within a holding company are key units of the system, piece-by-piece disposition would imply that sister banks are cut adrift, without the operating, accounting, and product delivery systems often centered in lead banks or the holding company itself. Units that might have been both solvent and liquid within the holding company structure would find their viability undermined if they had to maintain themselves as independent units -- units that would inevitably be tinged by their past association with a failed holding company organization. Nor are individual units of a holding company likely to be attractive to potential out-of-state acquirers. The associated uncertainties and potential disruptions are precisely what the bill is designed to avoid.

Conclusion

It is an unhappy fact that economic conditions in some states have brought strains and strong pressures on elements of the banking system in those areas. At the same time, there is every reason to believe those problems can be contained and diffused in a manner that will preserve and support the essential stability of the banking system, and thus avoid aggravating already difficult economic circumstances.

To assure that result, supervisory and regulatory agencies do need some limited additional authorities so that they can act with dispatch and at minimum cost, both in financial terms and in terms of maintaining confidence. Those authorities would be provided by S. 2372.

The bill has been carefully drafted to limit its scope totally to emergency situations for a limited period, at the same time reconciling conflicting demands of public policy. Congress in the past has acted with care and effectiveness in providing necessary authority to deal with problem areas in both the banking and thrift industries.

Failure to act now could only increase the risks that the ultimate costs would be far greater. We want to forestall a crisis, not to pick up the pieces after the damage has been done.

I strongly recommend you take the crucial further steps required by the present situation with the clear sense of urgency the situation demands.

Financial Institutions Emergency Acquisitions Amendments of 1986

I. General Provisions

The Federal banking regulators have requested that the Garn-St Germain Act of 1982--which permits acquisition across state lines of failed banks having assets of $500 million or more--be changed and augmented in the following respects:

-- That the size threshold for interstate emergency acquisitions be lowered from $500 million to $250 million.

-- That an interstate rescue be permitted when a bank is "failing"--in danger of closing--rather than actually closed.

-- That the interstate acquisition of a bank holding company or of some or all of the banks in a bank holding company be permitted if the assets of the banks in danger of closing in the holding company total $250 million or more and constitute at least 33 percent of the banking assets of the holding company.

-- That the out-of-state banking company be permitted to expand its operations to the three largest cities or metropolitan areas in the state of the acquired banking institution.

II. The In Danger of Closing Test

The bill provides a qualitative test to determine when an interstate acquisition may be made of a bank that is "in danger of closing."

-- A bank is defined as "in danger of closing" (1) if it is not likely to be able to meet the demands of its depositors or pay its obligations and there is no reasonable prospect for it to do so without federal assistance; or (2) if it has incurred or is likely to incur losses that will deplete all or substantially all of its capital and there is no reasonable prospect of replenishment of its capital without federal assistance; or (3) if there are other grounds for closing the bank under state law.

-- The appropriate federal or state chartering authority must certify in writing that a bank is "in danger of closing." The appropriate chartering authority is the State bank supervisor in the case of state chartered banks and the Comptroller of the Currency in the case of federally chartered banks.

III. State Banking Structure Protections

Careful protections to preserve the opportunity of an in-state solution are included in the legislation. The particular safeguards depend on whether or not the FDIC provides financial assistance in connection with the interstate acquisition.

A. Unassisted Acquisitions

In the case of acquisitions of failing institutions that take place without FDIC financial assistance:

-- Before a failing institution can enter into discussions with an out-of-state company, the State bank supervisor must be notified and the company must attempt to arrange an acquisition within the state or within its region if the state is part of a regional compact.

-- If in-state and regional efforts are unsuccessful, any application for an out-of-state acquisition must describe the efforts made to arrange an in-state or regional acquisition and the reasons for rejection of any in-state or regional proposal.

-- If an application is submitted for an out-of-state acquisition, the Federal Reserve must consult the State bank supervisor.

-- The State bank supervisor must be given a reasonable opportunity to object to approval of the application--in no event less than 48 hours.

-- The Federal Reserve cannot approve the application if the State supervisor certifies that an in-state or regional applicant has offered to acquire the institution and has the financial and managerial resources to be likely to be able to secure regulatory approval.

-- The in-state or regional applicant does not have to match or exceed the out-of-state bid. The in-state or regional offer need only be sufficient to recapitalize the failing banks and not involve FDIC assistance.

-- Only if the Federal Reserve determines that the in-state or regional party certified by the State supervisor does not have the financial resources to recapitalize the failing institution, can the Federal Reserve approve an out-of-state acquisition.

-- The acquisition must be approved by the board of directors of the bank that is in danger of closing or its holding company.

B. FDIC Assisted Acquisitions

In the case of acquisitions of failed banks or those that take place with FDIC financial assistance, the following safeguards are included in present law or in the proposed legislation:

-- The FDIC may assist a merger or acquisition across state lines only where the board of directors of a failing bank requests that the FDIC do so.

-- If the best offer--in terms of lowest cost to the FDIC--is made by an out-of-state company, then the FDIC shall permit any in-state or other bidder whose bid was within 15 percent or $15 million (whichever is less) of the best offer, to submit a new bid. In making a final determination on bids, the FDIC is directed to give priority to an institution from the same state. In considering offers from different states, the FDIC is required to give priority to offers from adjoining states.

- -- The FDIC must consult with the State bank supervisor before the FDIC can assist an interstate merger or acquisition.
- -- The State bank supervisor must be given a reasonable opportunity to object to the interstate merger or acquisition--in no event less than 48 hours.
- -- If the State supervisor objects to the interstate acquisition, the FDIC may go ahead with the transaction only by a unanimous vote of the FDIC Board of Directors, and a written certification of its decision must be provided to the State supervisor.

IV. Other Provisions

- -- The bill specifically prohibits providing financial assistance by the FDIC to any nonbanking subsidiary of a holding company in an assisted interstate transaction.
- -- If the FDIC provides financial assistance to a failing bank with total assets of $250 million or more and the bank is not acquired by an out-of-state company at the time the assistance is given, the bank and its holding company affiliates shall remain eligible to be acquired by an out-of-state bank or holding company as long as the assistance is outstanding.
- -- The Federal Reserve would be authorized to waive notice and hearing requirements in approving emergency acquisitions.
- -- The bill extends for five years the emergency provisions of Title I of the Garn-St Germain Act. Those provisions and the provisions added by this legislation would sunset in five years.

The **Chairman**. Thank you, Chairman Volcker.

Mr. Seidman.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, BOARD OF DIRECTORS, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. **Seidman**. Thank you, Mr. Chairman, members of the committee. I am pleased to be here today.

I want to start by saying I support the total statement of my fellow regulators that Chairman Volcker has given.

As you know, we handled 120 bank failures and assistance transactions in 1985. We expect a similar volume in 1986. At the present time we are approximately 10 ahead of the pace last year, including banks which are larger than those that failed last year.

BANK FAILURES HANDLED THROUGH P&A'S

We attempt to handle as many failures as possible through purchase and assumption transactions [P&A's]. These are less disruptive than payoffs to the affected communities. We grant equivalent treatment for small and large banks, and they are less costly than payoffs to the insurance funds; three very important reasons for handling the transactions in that way.

Let me turn now to the legislation before you. I will start by highlighting the conditions of the banking industry that make statutory reform essential.

The troubled bank problems we face are serious. Oil and gas banks are threatened by a continuation of today's low oil prices and oil and gas problems are on the rise.

While we face these problems, we want to deal with them on a statutory basis that will give deference to State authority over banking embodied in the Douglas amendment and the McFadden Act. We would prefer to rely on intrastate solutions.

Many of the failing bank situations we see today may not be resolvable, however, through intrastate solutions. In economically depressed States, strong willing buyers may not be available. Even healthy banks may find that troubled within-State institutions do not fit their business plans.

Where few or no within-State buyers can be found, it becomes important to expand the number of potential bidders. This can be done by allowing out-of-State banks to make bids.

This heightens competition and maximizes the bank's sale price. This reduces the cost to the FDIC, and thus—and I emphasize this—thus to other banks around the country.

This is a question of who is going to pay for what in bank failures. This is a question between those States who have banking systems which do not face failure paying for additional costs in those States which want to maintain their position and thus increase the cost to the FDIC.

The FDIC is a conduit. Its assets belong to the other banks. Therefore, when you force us to pay a higher price to maintain our insurance position, that price is paid directly by the other banks through increased premiums.

The new combined institutions tend to be healthier and more likely to succeed than mergers that result from purely in-State auctions.

We recognize that interstate acquisition provisions are on the books and have increased the FDIC's options in handling several bank failures, but these provisions have significant limitations. Existing law needs to be broadened and improved if we are to cope successfully with the failing bank situations we confront.

$250 MILLION THRESHOLD

As of the yearend 1985, 134 insured savings banks and 953 insured commercial banks had assets greater than $250 million. Of this total, 443 commercial banks had between $50 and $500 million in assets.

Our proposal would therefore almost double the number of commercial banks eligible for emergency acquisition transactions. Of the 1,087 total institutions, 78 were on our problem list. Of the 443 commercial banks between $50 and $500 million, 24 were on our problem list.

We also considered other alternatives to the $250 million threshold; for example, a proposal to include the 10 largest banks in each State and all banks presently meeting the $500 million threshold would represent an increase of 213 commercial banks eligible for acquisition.

An attachment to the testimony provides a detailed State-by-State breakdown of banks falling into the $250 to $500 million and over $500 million asset categories.

I will not repeat the proposals in our legislation, since I believe you are familiar with them.

We believe our proposal reflects our continued sensitivity to federalism concerns and the importance of the dual banking system.

Specifically, it provides State bank supervisors notice and an opportunity to object to proposed out-of-State assistance transactions.

It would provide for rebidding procedures in certain instances, giving the in-State institutions the first opportunity to make acquisitions.

We would not interfere with State banking law, State law standards for determining whether a bank is in danger of closing. In short, State interests would be amply protected.

We believe this legislation is a stitch in time. Being prepared has always been a rewarding position, and we would like to be prepared.

Mr. Chairman, that concludes my remarks.

[The complete prepared statement follows:]

STATEMENT ON

S. 2372, LEGISLATION TO STRENGTHEN THE EMERGENCY INTERSTATE ACQUISITION PROVISIONS OF TITLE I OF THE GARN-ST GERMAIN ACT

PRESENTED TO

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

BY

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

538 Dirsken Senate Office Building
May 13, 1986
9:00 a.m.

I. INTRODUCTION

Mr. Chairman, I want to start by expressing my appreciation to you for initiating prompt hearings on S. 2372, a proposal to broaden the emergency interstate acquisition provisions of Title I of the Garn-St Germain Act. We at the FDIC, in conjunction with the other federal bank regulators, seek to anticipate potential bank problems. Our goal is to resolve these problems with minimal disruption to our financial system and at minimal cost to our insurance fund. You know from experience that we are not infallible, but I trust you will agree that we are right to try.

I will center my testimony today on the economic conditions underlying the need for expanded emergency interstate bank acquisition authority. First, however, I would like to share with you some of our recent insights on the handling of bank failures. I believe this experience bears directly on the legislation you are considering.

II. HANDLING OF BANK FAILURES

Coping with bank failures has proved a formidable administrative challenge in recent years. The FDIC handled 120 bank failures and assistance transactions in 1985. We expect a similar volume in 1986, possibly including some institutions that are larger than those which failed last year.

We are attempting to handle these failures through purchase and assumption transactions whenever we are authorized to do so by law. P&A transactions are desirable for three distinct reasons. First, P&As are less disruptive than payoffs in the affected communities. A P&A minimizes customer disruption by keeping the failing bank's doors open -- albeit under a new name. Moreover, under a P&A, all deposits and most other liabilities to general creditors[1] are assumed by the acquiring bank. Thus, all depositors and most general creditors come out whole. In contrast, when a bank is liquidated through a payoff, uninsured depositors and other general creditors usually do not receive the full amount of their claims.[2] Second, reliance on P&As in lieu of payoffs helps dispel the perception that we handle small bank failures differently than large bank failures. Third, experience shows that P&As are less costly than payoffs to the Insurance Fund.

III. EMERGENCY INTERSTATE TAKEOVER LEGISLATION

Now let me return to the legislation currently before you. S. 2372 pertains to bank acquisitions involving FDIC assistance, as well as transactions not involving such aid. I will confine my remarks to assisted transactions. Before discussing specific provisions, I will review the changes in the banking environment that have created a need for the statutory modifications we seek.

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[1] The exception to this statement involves general creditor obligations, where they exist, in state-chartered banks located in states that have depositor preference statutes.

[2] In early 1984 the FDIC utilized "modified payoffs," under which insured depositors' accounts -- but not the liabilities of uninsured depositors and other general creditors -- are transferred to an acquiring bank. These transactions proved less disruptive than straight payoffs, while retaining some market discipline from bank creditors. Modified payoffs have been used infrequently in the past two years, usually in situations where a P&A was not feasible. See L. W. Seidman, Statement on Deposit Insurance Reform 6-7, Senate Comm. on Banking, Housing, and Urban Affairs, 99th Cong., 2d Sess. (Mar. 13, 1986).

Most of the failing banks we have seen in the past two years have been small. We have been able to deal with most of them effectively through intrastate acquisitions. In some cases, however, we have been unable to arrange P&As, due to a lack of interested within-state bidders.

The potential problems we face today are greater. Oil and gas banks are threatened by a continuation of today's oil prices. Assets of all the 62 farm banks that failed in 1985 would not equal the assets of the lead bank in some of those companies. In a recent survey, we identified 563 commercial banks as "energy" banks. Eighteen percent of them -- 103 institutions -- are on the problem bank list. At the April 1985 shared national credit review, 17.5 percent of oil and gas credits were criticized. The volume of problem loans is expected to expand dramatically in the next review, now under way.

While we prefer to rely on intrastate solutions, many of the failing bank situations we see today simply may not be resolvable through intrastate P&As. In some states, it may not be possible to find a buyer that is strong enough financially to make an acquisition of a failed or failing bank of moderate size. As recently as a year or two ago we had a sellers' market. In some areas of the country, we find we have to make deals increasingly attractive, even with very small banks. Furthermore, even healthy within-state institutions may not have an incentive to bid for troubled banks.

As we confront situations where few or no within-state buyers are to be found, it becomes important to expand the number of potential bidders. This can be done by allowing out-of-state institutions to make bids. Opening up [illegible] to out-of-state bidders greatly increases the pool of potential purchasers. It thereby heightens competition and maximizes a bank's sales price. This reduces costs to the FDIC and thus to other banks around the country. The new combined institutions tend to be more diversified and healthier than the ones that result from more limited auctions. As a result, both the stability of the banking system and economic efficiency are enhanced.

We prefer to rely on within-state solutions to troubled bank situations whenever feasible. We fully respect the deference to state authority over banking embodied in the Douglas Amendment and the McFadden Act. But if interstate banking is necessary, it should be accomplished directly. Our aim is to be given adequate tools to cope effectively with the failing bank situations we may confront.

The current interstate acquisition provisions have some very helpful features. They provide for out-of-state purchases of failed commercial banks and failed or failing mutual savings banks with assets of $500 million or more. These provisions have materially increased the FDIC's options and reduced its costs in handling several bank failures. In February of this year, for example, they were used in the failure of Park Bank in Florida, and at least $12 million was saved by the FDIC as a result of this transaction alone.

But these provisions have significant limitations. Eligible commercial banks may be acquired only if they are closed. In contrast, an eligible

mutual savings bank may be acquired prior to closing. Absent specific state legislation, existing law does not provide for acquisition of holding company affiliates of a failed or failing bank. In addition, if a bank is acquired by an out-of-state bank holding company, the bank may expand throughout the state by branching if permitted, but not by holding company acquisitions. This means in unit banking states, the out-of-state bank holding company's entry is limited to the site of the bank it acquires.

As a result, we believe that existing law needs not only to be extended but also to be broadened and improved. Our purpose is to provide the FDIC greater flexibility in order to reduce the cost to the Federal Deposit Insurance Fund and therefore to member banks, minimize disruption of financial services to the communities involved, and maintain the safety and soundness of the banking system as a whole.

Briefly, our proposal would do four things. First, it would lower the size threshold of a bank eligible for acquisition. Second, it would permit the acquisition of failing as well as failed commercial banks. Third, it would extend the scope of interstate acquisition authority to include bank holding company systems when the failing bank exceeds the statutory size threshold and represents a sizeable part of the holding company system. Fourth, it would authorize acquiring banks to expand to the three largest metropolitan statistical areas in the state of acquisition. Our proposal also reflects our sensitivity to federalism concerns and to the continued importance of the dual banking system.

Lowering the Size Threshold

Now for some specifics. The existing interstate provision works this way. When a bank of $500 million or more in total assets is closed, the FDIC, as receiver, may arrange the sale of assets and assumption of liabilities of the closed bank by an out-of-state bank or holding company. The $500 million threshold is too high a hurdle, as most troubled banks are considerably smaller. We propose a reduction to at least $250 million.

As of year end 1985, 134 insured savings banks and 953 insured commercial banks had assets greater than $250 million. Of this total, 443 commercial banks had between $250 million and $500 million in assets. Our proposal would therefore almost double the number of commercial banks eligible for emergency acquisition transactions. (Of the 1,087 total institutions, 78 were on our problem list. Of the 443 commercial banks between $250 million and $500 million, 24 were on the problem list.) We also considered other alternatives to the $250 million threshold. For example, a proposal to include the ten largest banks in each state or all banks presently meeting the $500 million threshold would represent an increase of 213 commercial banks eligible for acquisition. An attachment to this testimony provides a detailed state-by-state breakdown of banks falling into the "$250-500 million" and "over $500 million" asset categories.

Others have suggested that the threshold should be lowered further or eliminated altogether for a temporary period for farm banks. Should the Congress decide to do this, the FDIC would have no objection. We would note however, that a small farm bank in a unit banking state would probably not attract many out-of-state bids. On the other hand, in unit banking states that permit multibank holding companies, interstate buyers might be attracted to purchasing the holding company. Permitting this at a threshold lower than $250 million might help resolve some problems in the agricultural sector.

Failing Bank Assistance

Second, arranging an assistance transaction for a failing bank before failure can be cost effective. Franchise value would be less eroded by the flight of bank customers and tax benefits may be retained. This would increase the bank's sales price, thereby decreasing the FDIC's costs and increasing our flexibility to pass assets. In addition, this could avoid the process of decline into insolvency that might create a ripple effect in the financial community. Thus, an out-of-state acquisition should be permitted not only for failed banks, but also for banks in danger of closing, i.e., banks that are expected to close if assistance is not provided.

Holding Company Acquisitions

Third, if the failing bank or banks exceed the statutory size threshold and represent a sizeable part of the bank holding company system, an out-of-state holding company should have the ability to buy the stock of the failing bank and to buy stock of any of the bank's affiliates. The existing law does not provide for the situation where a failing bank is an integral part of a larger banking organization. Because healthy holding company affiliates cannot be acquired, potential acquirers may be willing to pay far less than otherwise for a troubled bank. This diminution in a bank's sales value may raise the FDIC's costs. It may also result in the dismemberment of existing established systems, with disruptive effects in the local community.

Post-Acquisition Expansion

Fourth, acquiring institutions would automatically be entitled to expand into the three largest metropolitan areas in the acquired bank's state, under the same conditions applied to bank holding companies already located in that state. This would enhance institutions' incentives to bid on troubled banks and thereby increase the total number of troubled bank P&As that can be carried out -- to the benefit of depositors, creditors, and affected communities. At the same time, the limitations on the scope of expansion would allow states to retain substantial control over bank expansion within their borders.

Safeguards

The proposal reflects our continued sensitivity to federalism concerns and the importance of the dual banking system. When the existing interstate legislation was enacted in 1982, Congress provided specific safeguards to protect the states' interests. Our proposal retains these safeguards. It does this: (1) by providing state bank supervisors notice and an opportunity to object to proposed out-of-state assistance transactions; (2) by authorizing state bank authorities to determine whether a state-chartered institution is "failing", for purposes of out-of-state bids; and (3) by providing for rebidding procedures under certain circumstances. These safeguards provide an important role for state banking supervisors.

IV. CONCLUSION

Mr. Chairman, that concludes my prepared remarks. I would be pleased to answer any questions you may have.

Attachment

All Insured Commercial Banks with Assets greater than $250 Million
As of December 31, 1985
($ Amounts in Millions)

STATE	Number of Banks w/ Assets of $250 - $500	Assets of Banks w/ Assets of $250 - $500	Number of Banks w/ Assets Over $500	Assets of Banks w/ Assets Over $500
ALABAMA	7	$2,134	5	$14,013
ALASKA	4	$1,477	3	$2,605
ARIZONA	0	$0	6	$22,850
ARKANSAS	8	$2,793	2	$1,864
CALIFORNIA	22	$8,167	29	$259,559
COLORADO	6	$1,969	4	$8,103
CONNECTICUT	4	$1,156	6	$21,385
DELAWARE	4	$1,583	6	$7,171
DISTRICT OF COLUMBIA	3	$1,089	5	$13,315
FLORIDA	27	$9,255	29	$52,277
GEORGIA	7	$2,369	9	$29,370
HAWAII	1	$360	4	$8,405
IDAHO	2	$718	3	$5,471
ILLINOIS	54	$11,409	17	$90,551
INDIANA	20	$6,308	13	$18,152
IOWA	4	$1,370	4	$3,808
KANSAS	8	$2,676	2	$2,229
KENTUCKY	6	$1,825	5	$10,824
LOUISIANA	13	$4,733	14	$15,678
MAINE	1	$387	5	$3,691
MARYLAND	2	$661	11	$26,749
MASSACHUSETTS	21	$7,775	17	$50,559
MICHIGAN	26	$8,910	17	$41,684
MINNESOTA	10	$3,191	6	$23,758
MISSISSIPPI	5	$1,652	5	$7,555
MISSOURI	10	$3,302	11	$19,029
MONTANA	3	$938	0	$0
NEBRASKA	1	$487	4	$4,573
NEVADA	1	$461	4	$6,416
NEW HAMPSHIRE	6	$2,103	1	$667
NEW JERSEY	14	$6,418	29	$47,119
NEW MEXICO	3	$951	2	$2,585
NEW YORK	15	$5,624	46	$632,987
NORTH CAROLINA	2	$534	10	$45,322
NORTH DAKOTA	1	$275	0	$0
OHIO	16	$5,463	28	$57,163
OKLAHOMA	8	$2,512	5	$8,341
OREGON	2	$577	4	$14,842
PENNSYLVANIA	18	$6,245	41	$108,635
RHODE ISLAND	1	$396	2	$8,216
SOUTH CAROLINA	1	$312	5	$11,035
SOUTH DAKOTA	1	$252	4	$11,898
TENNESSEE	7	$2,469	11	$19,224
TEXAS	52	$18,580	41	$97,572
UTAH	2	$526	5	$7,967
VERMONT	4	$1,809	1	$850
VIRGINIA	7	$2,308	10	$33,794
WASHINGTON	2	$791	7	$26,937
WEST VIRGINIA	6	$1,999	1	$535
WISCONSIN	9	$2,697	7	$10,265
WYOMING	2	$558	0	$0
PUERTO RICO	4	$1,527	4	$8,754
	443	$152,081	510	$1,896,332

The CHAIRMAN. Thank you, Mr. Seidman.
Mr. Clarke.

STATEMENT OF HON. ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Mr. Chairman, thank you for the opportunity to present my views this morning on S. 2372. I, like the other members of the panel this morning, have submitted a written statement, which I would appreciate having incorporated into the record.

The CHAIRMAN. It will be.

Mr. CLARKE. It is no secret that a number of banks are experiencing financial difficulty. I recently testified before the House Banking Committee on the problems facing national banks that have exposure to weakened sectors of the economy. All of us on the panel this morning have talked at various times with each of you about the concerns we share.

PROTRACTED BANK FAILURES

It is an unfortunate fact that the current high rate of bank failures is expected to be with us for some time—at least under our present system of dealing with bank failures. It is therefore more important than ever before that we deal with each failure in a way that minimizes any disruption in the provision of banking services to the community, the potential for a decline in public confidence in the banking system, and its cost to the FDIC. The acquisition of a troubled bank by a stronger institution is often the solution that minimizes the adverse effects that can result from the failure of a bank.

It is important to recognize, however, and it is perhaps not a coincidence, that almost two-thirds of the problem banks are in unit banking States or States that otherwise limit branching. Such restrictions limit the number of in-State options for the acquisition of failing banks and reduce the number of bidders for failed banks, making it more difficult for the FDIC to arrange purchase and assumption transactions. If a purchase and assumption cannot be arranged, the FDIC must choose between liquidating a failed bank and paying off its depositors or propping it up with FDIC-provided capital.

Our office, the Federal Reserve Board, and the FDIC believe that expanding the number of potential acquirers of weak banks and removing some of the constraints on out-of-State purchasers of these banks will enhance our ability to resolve weakened bank situations in an expeditious, least-cost manner.

Rather than discuss the particular provisions of the bill, which Chairman Garn outlined in his opening statement, I would like to concentrate on several areas of the legislation about which concerns have been expressed.

The first of these is that the bill gives too much discretion to a bank's primary supervisor to decide when a bank is in danger of failing and therefore eligible for emergency interstate acquisition. Some have suggested, for example, that a bank not be declared to be failing until its capital falls to a particular level, say 1 percent, or until the only primary capital that remains is the bank's loan loss reserve.

I can appreciate the desire for greater precision. In fact, as the person who would be responsible for determining if a national bank is failing, I would say that having a list of specific criteria would make my job a lot easier. But, in my judgment, it would weaken our effectiveness in dealing with the problem.

The events that precede a bank's failure can differ greatly, and no one specific definition would work well in all cases. I believe that the bill provides a proper balance between the supervisor's need for flexibility and the need to be cautious in declaring a bank to be in danger of failing.

Ideally, our examiners would be able to pinpoint when the market value of a national bank's capital has been exhausted. Unfortunately, the measurement of an institution's capital is not an exact science. It is often difficult to establish the precise value of assets and put a value on contingent liabilities. Also, making such valuations through the examination process takes time, during which conditions can change.

Furthermore, eligibility based solely on the level of capital would restrict the use of emergency acquisition authority in cases where a bank still had positive capital but was experiencing severe liquidity problems and was thus in danger of liquidity insolvency.

CLEAR PREFERENCE TO IN-STATE BANKS

Some have said that S. 2372 would do violence to existing restrictions on interstate banking. That is simply not the case. In unassisted transactions, a clear preference is given to in-State or in-region—if the State is in a region—acquisitions. In the case of assisted transactions, the FDIC currently has the authority to seek purchasers from States in a bank's interstate banking region as well as its own State. This bill would not change that authority.

Moreover, the bill provides State banking supervisors with a significant role. State supervisors could effectively veto any proposed unassisted out-of-State acquisition by demonstrating that there exists a willing in-State purchaser with sufficient managerial and financial resources to make the acquisition, and, as you know, State supervisors make the determination as to whether a State bank is failing.

Suggestions have also been made that amendments to S. 2372 should impose concentration limits on bank holding companies that enter a State via emergency acquisition. Similarly, it has been suggested that such entrants make explicit commitments to invest in the local economy. In my view, such amendments would introduce unnecessary complications in the bill. S. 2372 is intended to deal with an emergency situation. It would not change current antitrust law with respect to concentration or the laws regarding community reinvestment obligations for banks. Moreover, the acquisition of a failing bank in and of itself represents a significant financial commitment to the local community. I simply see no reason that those issues should become part of the debate on emergency legislation.

Mr. Chairman, this bill is intended to provide bank supervisors with the flexibility to deal with a large number of weakened institutions in the banking system. It is not an end run around the Douglas amendment, nor is it an effort to effect sweeping changes in the relative roles of the Federal and State regulatory agencies.

This bill is intended solely as a means of facilitating the resolution of failures and near failures in the banking industry. We sincerely hope we will never have to use the powers if they are granted. Indeed, the current emergency acquisition provisions of the Garn-St Germain Act have been invoked only infrequently, but when they have been used, they have saved the FDIC significant dollars. It appears to me that we can better manage the problems posed by failing institutions if we have better tools to do that job. As a matter of fact, the mere availability of these tools may provide some stability to the banking system by reassuring depositors that there exists a means for achieving an orderly transition of ownership of a troubled institution.

If these tools do have to be used, I believe they would help minimize the disruption to the community, any loss of public confidence, and the cost to the FDIC insurance fund involved in resolving a weakened bank's problems. I would therefore underscore Chairman Volcker's urging that this committee move ahead as soon as possible with this legislation and give it immediate and favorable consideration.

Thank you very much.

[The complete prepared statement follows:]

For Release Upon Delivery
May 13, 1986, 9:00 a.m.

STATEMENT OF ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
UNITED STATES SENATE
May 13, 1986

Mr. Chairman and members of the Committee, I welcome this opportunity to present my views on S. 2372, a bill that would amend the emergency acquisition provisions of the 1982 Garn-St Germain Act.

Today I would like to discuss the need for additional flexibility to enable bank supervisors to deal more effectively with weakened banks. The bill, which is the subject of these hearings, is designed to provide that flexibility.

NEED FOR ADDITIONAL FLEXIBILITY

It is no secret that a number of banks are experiencing financial difficulty. I recently testified before House Banking Committee on the problems facing national banks that

have exposures to weakened sectors of the economy. Currently, there are nearly 300 national banks on our problem list (banks with a CAMEL rating of 4 or 5), an increase of almost 400 percent over year-end 1983. Almost 75 percent of these banks are located in the Midwest and Southwest, areas that have been especially hard hit by downturns in the energy industry, the agricultural industry, or both.

It is an unfortunate fact that the current high rate of bank failures is expected to be with us for some time -- at least under our present system of dealing with bank failures. It is therefore more important than ever before that we deal with each failure in a way that minimizes any disruption in the provision of banking services to the community, the potential for a decline in public confidence in the banking system, and its cost to the Federal Deposit Insurance Corporation (FDIC). The acquisition of a troubled bank by a stronger institution is often the solution that minimizes the adverse effects that can result from the failure of a bank.

It is important to recognize, however, and it is perhaps not a coincidence, that almost two-thirds of the problem banks are in unit banking states or states that otherwise limit branching. Such restrictions limit the number of in-state options for the acquisition of failing banks and reduce the number of bidders for failed banks, making it more difficult for the FDIC to arrange purchase and assumption transactions. If a purchase and assumption cannot be arranged, the FDIC must choose between liquidating a failed bank and paying off its depositors or propping it up with FDIC-provided capital.

Our Office, the Federal Reserve Board, and the Federal Deposit Insurance Corporation believe that expanding the number of potential acquirors of weak banks and removing some of the constraints on out-of-state purchasers of these banks will enhance our ability to resolve weakened bank situations in an expeditious, least-cost manner. The three agencies have collaborated on drafting legislation that would provide us with those tools by amending the emergency acquisition provisions of the 1982 Garn-St Germain Act.

The Administration has completed its review of this legislation. Mr. Chairman, I can report to you that the Administration strongly supports S. 2372. I should note, however, that the Department of Justice has recommended two clarifying changes to the bill regarding the application of antitrust laws to emergency interstate acquisitions. We would be happy to work with the Committee staff to make those changes. I will now turn to the primary features of our proposal.

PROVISIONS OF THE BILL

The proposed legislation would amend the emergency acquisition provisions of the 1982 Garn-St Germain Act in four important ways. First, the bill extends the emergency aquisition provisions to authorize out-of-state commercial banks to acquire weakened banks before they fail. The current law requires that a commercial bank be closed before an out-of-state purchaser can be sought. Second, the bill defines banks that have at least $250 million in assets as eligible for emergency acquisitions. Currently, only institutions with at least $500 million in assets are eligible. Third, the bill extends the emergency acquisition provisions to bank holding companies with a subsidiary bank or banks in danger of closing. Fourth, the bill provides limited expansion opportunities for out-of-state holding companies that acquire troubled institutions. The bill also provides for out-of-state acquisitions of failing banks in instances where no FDIC assistance is involved.

Expanding eligibility to failing banks. Authorization of out-of-state acquisitions of weakened institutions before they fail would expand the FDIC's options for dealing with those banks. A bank that is still operating is more likely to attract favorable bids than is a closed bank because the open bank's value as an ongoing business can be preserved.

Consequently, we expect that a smaller commitment of FDIC funds would be required to resolve the situation. Moreover, reducing the total number of bank failures would help maintain the stability and confidence in the banking system as a whole.

The bill establishes three criteria, any one of which would be sufficient to declare an institution in danger of closing, and it would be up to a bank's primary supervisor (the state bank supervisor in the case of a state bank; the OCC in the case of a national bank) to determine whether it meets any of the criteria. The first two are that in the absence of Federal assistance, the bank is not likely to be able to meet the demands of its depositors or pay its obligations as they become due (so-called liquidity insolvency), or that the bank has incurred or is likely to incur losses that will deplete substantially all of its capital and cannot be expected to replenish its capital (so-called capital insolvency). The third criterion is the existence or likely existence of any other grounds for closing a bank that are provided for in state law.

Lower size threshold for eligible institutions. Making banks with fewer than $500 million in assets eligible for the emergency acquisition provisions of the Garn-St Germain Act will enhance the FDIC's ability to arrange for the purchase and assumption of mid-sized banks. There are only a limited number of banks in any one state that are large enough to safely purchase another large or mid-sized bank in danger of failing. Because banks play an important role in the economic life of their communities, we believe that it is critical that the FDIC have maximum flexibility in resolving any problems they experience.

Unfortunately, the sectoral problems affecting entire states, and the concentration of troubled banks in those states, increase the likelihood that it will be difficult to find strong in-state institutions willing to rescue weak institutions without substantial financial assistance from the FDIC. Thus, in the absence of alternative solutions, such as out-of-state acquisitions, it is likely that the FDIC will be forced to perform more liquidations and deposit payoffs, with a resulting loss in banking services to local communities. The bill would reduce the minimum threshold to $250 million in assets.

Extension to holding companies. The bill extends the emergency acquisition provisions to holding companies that have a subsidiary bank or banks in danger of closing if such bank or banks have assets of at least $250 million and hold one-third or more of the total assets of the holding company's bank subsidiaries. In addition to allowing the acquisition of these failing banks, the bill permits an out-of-state purchaser to acquire some of the holding company's other bank subsidiaries or the entire holding company. It would not, however, permit FDIC assistance to be provided to nonbank subsidiaries of the holding company.

This addition to the law will facilitate emergency acquisitions in states that prohibit branching but allow multi-bank holding companies. Under current provisions of the Garn-St Germain Act, an out-of-state bank holding company that acquires a troubled institution is not permitted to acquire other banks in that state. Thus, potential acquirors are deterred by the prospect of being limited to a single office location and purchasing what is, quite likely, the most troubled part of the holding company.

Moreover, if the troubled bank is the lead bank of the holding company, stripping it out of the holding company could affect the safety and soundness of the smaller affiliate banks in the holding company. Similarly, breaking up the holding company could have disruptive effects on the local community and the banking system. The proposed change would mitigate these problems by allowing the entire holding company to be acquired.

Additional expansion opportunities. The bill authorizes out-of-state bank holding companies that acquire a troubled institution to acquire, at any future time, additional banks located in the three largest metropolitan areas, consolidated metropolitan statistical areas, or cities in the state in which the acquired troubled bank is located. This amendment reduces, but does not eliminate, some of the competitive disadvantages that out-of-state acquirors face relative to in-state holding companies. Without at least some opportunities for expansion, out-of-state companies do not have much incentive to bid for a troubled bank in unit banking states.

Unassisted acquisitions. In addition to making these four changes to the 1982 Garn-St Germain Act, the bill introduces another concept: it amends the Douglas Amendment of the Bank Holding Company Act to provide for out-of-state acquisitions of failing banks in instances where no FDIC assistance is involved. This would encourage weakened institutions to find private solutions to their problems before those problems reach a stage that demands federal financial assistance, further reducing potential demands on the FDIC's resources.

The size thresholds for the unassisted out-of-state acquisitions would be the same as for FDIC-assisted acquisitions. Likewise, the provisions dealing with the acquisition of the holding company and its healthy banks, as well as subsequent expansion rights would be similar to the provisions made for assisted acquisitions.

Recognizing the possible concerns of states regarding out-of-state acquisitions, the bill provides the state banking supervisors with a significant role in these transactions. First, the bill, in effect, requires that the target bank or bank holding company exhaust all in-state alternatives before seeking a potential out-of-state acquiror. Second, the state supervisor may effectively veto a proposed out-of-state acquisition by demonstrating that there exists a willing in-state purchaser with sufficient financial and managerial resources to acquire the bank or bank holding company. This will prevent shareholders of a weakened institution from realizing a windfall gain attributable solely to the institution's eligibility for acquisition by an out-of-state purchaser. This approach gives states the opportunity to find their own solutions when banks are in danger of failing. Where no in-state solution is available, it facilitates the use of out-of-state sources of capital.

CONCLUSION

Mr. Chairman, some have said that this bill would make an end run around the Douglas Amendment. I can state categorically that that is not the case. Nor is it an effort

on our part to effect sweeping changes in the relative roles of federal and state regulatory authorities.

This bill is intended solely as a means of facilitating the resolution of failures and near-failures in the banking industry. We sincerely hope that we will never have to use the powers if they are granted. Indeed, the current emergency acquisition provisions of the Garn-St Germain Act have been invoked only infrequently. It appears to me, however, that we could better manage the problems posed by failing institutions if we had better tools to do that job. As a matter of fact, the mere availability of these tools may provide some stability to the banking system by reassuring depositors that there exists a means for achieving an orderly transition of the ownership of a troubled insitution.

If these tools do have to be used, I believe that they would help minimize the disruption to the community, any loss in public confidence, and the cost to the FDIC insurance fund involved in resolving a weakened bank's problems. I therefore urge the Congress to give S. 2372 immediate consideration.

The **CHAIRMAN**. Thank you, Mr. Clarke.

Gentlemen, I am going to reserve my questions at this point and turn to other members of the committee because we do have a potential time problem. We have the Scharansky ceremony in the rotunda of the Capitol at 11 a.m.

Senator Proxmire.

Senator **PROXMIRE**. Chairman Volcker, a story in the Wall Street Journal April 24 reported on your testimony before a House committee on the rapid rise in debt. Here is an excerpt from that story, and I quote:

> Asked whether the Fed had plans to take any new measures to help troubled banks in the oil-producing States, Mr. Volcker said the Fed already has an effective apparatus to deal with these problems.

What has happened to the Fed's effective apparatus since April 24?

Mr. **VOLCKER**. Nothing. I think I referred in my statement to the willingness and ability to provide this kind of assistance to banks with liquidity problems, with shifting deposit flows emerging out of this situation.

I did not mean in that statement—I don't remember the context—to cast any doubt upon the desirability of this legislation, something I certainly had in mind at the time.

Senator **PROXMIRE**. Well, it seems to me when you say that the Fed has an effective apparatus to deal with these problems in the oil-producing States, that suggests that you don't really need actions that would let you override the right of the States to determine whether or not holding companies can come in and acquire their banks.

Mr. **VOLCKER**. I don't remember the context of that statement, but we have some powers, and we certainly would use them. But I strongly feel that this legislation would provide a margin of protection potentially important to the stability of banking in those areas and enable us to take care of the situation more expeditiously and at less cost than with existing tools, whether they are Federal Reserve or FDIC existing tools.

STATES HAVE ACTED EXPEDITIOUSLY

Senator **PROXMIRE**. Mr. Clarke, in the past when we have had actual as opposed to potential banking crises States have acted expeditiously to address the situation.

For example, the Washington State Legislature acted in the Seafirst matter to allow the Bank of America to acquire it. Ohio and Maryland have each acted more recently. The Oklahoma State Legislature is acting right now with respect to problems that have resulted from a decline in energy prices.

Given the fact that States have the capacity and the responsibility to act when necessary, why should the Federal Government now be in such a big hurry to take over a function which arguably is better left to the States to handle?

Mr. **CLARKE**. Senator, you make a good point, and I am encouraged, as you are, by the fact that these States have taken action.

As you know, I have been saying for some time that the States that find themselves in economic trouble should do whatever they can individually to create an environment for solving the problem, and I applaud those States for taking such action. The fact is, though, that there are some very large institutions that are located in States that have not taken that action. From our viewpoint as Federal bank supervisors, we believe that we need to have available all the tools we can possibly have to minimize the disruption if we should have to deal with a failing or failed institution.

Senator PROXMIRE. Including the authority to override State law?

Mr. CLARKE. Yes, sir; under the limited circumstances outlined in the proposed legislation.

Senator PROXMIRE. Chairman Volcker, it has been suggested that given the passage of time it is too late to close the nonbank bank loophole. Some have even suggested that the Congress make the nonbank bank loophole legitimate in the form of consumer or family banks.

What are your current views on the nonbank bank loophole?

Mr. VOLCKER. I think it ought to be closed, and I think it is still possible to close it.

Senator PROXMIRE. Do you think we should take whatever opportunity we have to close it?

Mr. VOLCKER. What I would prefer to see is that that be done as part of a balanced, larger piece of banking legislation.

Senator PROXMIRE. Well, as you know, Senator Garn has done a superb job as chairman of this committee, but he has had a very difficult time with the House. They look at it a different way, and it seems to me we have to take whatever train is going out of the station, including this regulators' bill.

Mr. Seidman, under your current emergency acquisition authority a bank must be declared insolvent before it can be sold out of State. That typically means the FDIC is appointed the receiver. Any proceeds from the sale of the bank's assets go to the FDIC. These funds are used to offset FDIC expenses. Stockholders get nothing initially and nothing in the long run unless there is a surplus left after covering all of the FDIC expenses.

But under this proposal, your new proposal, a bank need not be insolvent before being sold. That means there is no FDIC receivership, and any proceeds from the sale would presumably go to the stockholders. In some cases this payment to the stockholders would be at a substantial premium over the book value of the bank stock. Unlike current law, the stockholders could get this money immediately and would not have to wait until all the bad assets had been liquidated.

RULES ON STOCKHOLDER ASSISTANCE

As I understand the premise behind your new proposal, you want to sell a bank that is on the verge of failing even though it is not yet technically insolvent.

That being the case, why should the stockholders be put in any better position than they would be if the bank had actually failed? If the bank is indeed on the verge of failure, why should the stockholders walk away with anything?

Mr. SEIDMAN. Senator, first, if you are referring to an assisted transaction; that is, a failing bank transaction where we are providing some assistance, then under our rules as we have formulated them the stockholders would not be allowed to have any assistance except perhaps the minimal interest necessary to maintain a stock ownership in the marketplace.

But our rules do not allow us to provide assistance which will allow shareholders to make any gains.

Senator PROXMIRE. But in fact under this proposal, with a failing bank the FDIC would not be the receiver and would not be in a position to take the assets of this bank. The stockholders would get a reward.

If we do pass this legislation—why shouldn't we provide that the stockholders in a failing bank would get nothing?

Mr. SEIDMAN. Senator, if it is an assisted transaction, before we give that assistance we provide that the stockholders will not make any gain and that their interests will be substantially reduced or eliminated.

Senator PROXMIRE. Why can't we put that right into the bill itself?

Mr. SEIDMAN. I don't suppose there would be any objection. It is difficult in each case to evaluate exactly what interests they might have, but in any event, it is very clear, based on our past history and our own rules, that we would not allow the shareholders to make a gain.

Senator PROXMIRE. Comptroller Clarke, one argument given for your bill is the need to maintain the confidence of the public in the safety of the banking system. The argument seems to be that if we prevent a bank from failing by selling it interstate we somehow maintain confidence. However, if we allow that bank to fail, it could also be sold interstate under your current authority.

Therefore, your proposal rests on the assumption that the public makes a major distinction between a bank that has failed and a bank that is about to fail. In either case the regulators must take emergency action by selling the bank out of State.

So even under your proposal, the public must surely have known the bank in question was about to fail. Therefore, why do you believe selling a failing bank would be so much better in maintaining confidence as opposed to selling it when it has actually failed?

Mr. CLARKE. Senator, it just seems to me on its face that, even though the public may be well aware that a bank is in a weakened condition, it is preferable to have that bank acquired while it is still alive and before the headline reads "XYZ Bank Closed" or "XYZ Bank Failed." That just creates a better perception in the minds of the public.

Senator PROXMIRE. If the headline says "XYZ Bank Is Failing," that is better than "It Has Failed"?

Mr. CLARKE. If it has been acquired, somebody has had to make a determination that it was failing in order for it to be acquired, but the headline I think would read differently and in general would read after the fact. I think that is an important distinction. Also, when you have a failed bank, the FDIC is left with the pieces and becomes the banker with respect to a large number of the loans. If there is any way to get the management of those loans and the ultimate collection of those loans in the hands of another bank, the community is better off and the borrower is better off.

Senator PROXMIRE. Chairman Volcker, a review of publicly available data fails to substantiate any kind of bank emergency in the Southwest. For example, discount lending at the Federal Reserve Bank of Dallas increased by only $12 million over the last several weeks, and that is peanuts.

I further understand that the Federal Reserve has collected statistics on individual banks that would help to support its legislative proposal. However, your staff indicates that these figures are proprietary and cannot be shared with this committee.

If you cannot furnish us with the data on which you relied to make your judgment, how can you reasonably expect the committee to act on your recommendations?

Mr. VOLCKER. I think we are in a bit of a dilemma, Senator.

I think it is appropriate for us to review the condition of specific banks. That would obviously raise the specter of questions about the future of different banks and would differentiate among them in a way which I don't think is consistent with dealing with the situation in an orderly way.

We are caught in a bit of a dilemma in that respect.

Senator PROXMIRE. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

PROBLEM STATES

Senator GORTON. Chairman Volcker, I would like to follow up and ask a slightly different question than Senator Proxmire asked of one of the other panelists.

You state in your written statement, and I quote, "The case for this legislation is widely acknowledged in the States most directly concerned."

If that is the case, why haven't those States moved to loosen interstate banking or branching restrictions?

Mr. VOLCKER. At least one of them has. As Senator Proxmire indicated, the State of Oklahoma has. The action is all completed in terms of a response to this particular situation.

In other States, that kind of action may be more difficult or nonexistent, so we have a mixed record.

Senator GORTON. Texas would be a case in point. Why should we overrule the judgment of the legislature of Texas? If it doesn't think this is a serious problem, why should we?

Mr. VOLCKER. Perhaps we have a somewhat different perspective and are balancing interests somewhat differently. Collectively, at least, we have the responsibilities generally for the safety and soundness and stability of the banking system. We may view those responsibilities from a slightly different angle than the legislature in the State of Texas, and I don't think we can defer those responsibilities to the States if they are not willing to act themselves.

Senator GORTON. Can you tell me whether or not there is any serious move to do something with respect to this challenge in Texas?

Mr. VOLCKER. I am not aware of anything underway in the State of Texas. I have been told that they have other political problems in the State of Texas that make it unlikely that a special session of the legislature will be called for extraneous reasons.

What truth there is to that I do not know, but I know there is a lot of somewhat mixed feeling. There is a lot of sentiment in the State of Texas, in the banking community and elsewhere, that would welcome Federal legislation.

Senator GORTON. Mr. Seidman, what portion of your interstate-assisted mergers do you assist before putting a bank into receivership? Is it typical or only occasional?

Mr. SEIDMAN. It is only occasional, Senator, that we assist a bank on a temporary basis before we come to a solution of either paying off——

Senator GORTON. If that is the case, why is it important with respect to interstate mergers that you have that power?

Mr. SEIDMAN. When we need it, we usually need it rather badly because it is the kind of transaction that cannot be handled in a normal way. It is usually a bank that is very large or there are difficult situations to analyze or other special circumstances.

Senator GORTON. Do you think you would use the power more frequently in interstate cases than you would in intrastate?

Mr. SEIDMAN. I think it is likely that we would, although that is hard to forecast. But those would not be the normal transactions.

Senator GORTON. With respect to holding company acquisitions, you say, and I am quoting from your statement: "The existing law does not provide for the situation where a failing bank is an integral part of a larger banking organization."

Is that also true for intrastate mergers, or does that apply only in interstate cases?

Mr. SEIDMAN. I guess the intrastate mergers would depend on State law. Each State's law would govern that.

Senator GORTON. What do you do now to assist bank holding companies on an intrastate basis, anything?

Mr. SEIDMAN. We don't assist the holding companies in general. We deal with the banks themselves.

Senator GORTON. But if you got this power, you would expect to deal with some frequency with holding companies?

Mr. SEIDMAN. This power would not apply to intrastate holding companies.

Senator GORTON. I am speaking of the powers you seek. You would expect to deal with holding companies, interstate holding companies?

Mr. SEIDMAN. We can deal with holding companies if it is part of a solution which gives us a least cost solution to a bank failure.

Senator GORTON. How many times has the Corporation used the emergency acquisition powers of Garn-St Germain since they were enacted?

Mr. SEIDMAN. Three times.

LIQUIDITY INSOLVENCY

Senator GORTON. Mr. Clarke, your statement includes the proposition that one of the criteria which could prompt an interstate merger under the proposed bill is what you call a liquidity insolvency, which you are careful to distinguish from a capital insolvency.

I don't believe I have heard that term "liquidity insolvency" before.

What does it mean?

Mr. CLARKE. Senator, that means that the bank has reached a point where it is unable to fund itself. As you know, banks take money in and they lend money out. If they have reached the point where they are not able to take enough money in to meet all their obligations, then they have become insolvent from a liquidity standpoint, even though they might have plenty of capital.

Senator GORTON. So it doesn't mean that its liabilities exceed its assets?

Mr. CLARKE. That is correct.

Senator GORTON. It does mean then it is unable to meet withdrawal demands because its assets aren't readily convertible to cash?

Mr. CLARKE. That can be one of the circumstances.

Senator GORTON. If that is the circumstance, why isn't the traditional solution of temporary borrowing from the Federal Reserve sufficient.

Mr. CLARKE. I think you chose the right word. That is a temporary solution.

As you heard Chairman Volcker indicate this morning, that assistance is available from the Fed. It is there to be used. But as you know, under the bill the test of a failing institution from a liquidity standpoint is whether it is unable to meet its demands in the ordinary course of business and unable to meet those demands without Federal assistance. I interpret that to mean that long-term the institution would not be able to get out of the window, that it would have no ability to fund itself without some Federal assistance. Short-term borrowing from the Fed would not cause a bank to be a failing institution.

Senator GORTON. Has it been your experience since you have made this proposal, the entire proposal, that this aspect of it is one that causes fear in some States and among some State regulators, that it authorizes you to utilize these interstate authorities too freely or too readily when there really isn't a capital deficiency problem?

Mr. CLARKE. There has been the suggestion that the definition of a failing institution be tightened, that there be specific criteria set forth. While that is always a possibility, it is my judgment that that inhibits the supervisory authorities more than they should be inhibited because each failing bank situation presents a different set of circumstances.

Senator GORTON. So it is something you might be able to live with but you don't really desire?

Mr. CLARKE. I think any time you limit the flexibility to deal with a variety of situations you have hampered our effectiveness.

Senator GORTON. Under current law, how do the bank expansion powers permitted by Garn-St Germain, takeovers, compare to the expansion powers of in-State banks? Specifically, are out-of-State purchasers prohibited from acquiring additional banks in States where holding companies are the traditional method of geographic expansion?

Mr. CLARKE. Let me be sure I understand the question. If an out-of-State holding company acquires a bank in-State?

Senator GORTON. Are out-of-State purchasers prohibited from acquiring additional banks in States where holding companies are the traditional method of geographic expansion?

Mr. CLARKE. It depends on the law of the State, Senator.

Senator GORTON. In those States where in-State holding companies can make whatever acquisitions they want, that is usually the method where there are severe limits on branch banking in-State?

Mr. CLARKE. That is correct.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, it is nice to see you here this morning.

What are the criteria by which you would make a determination as to when an institution is a failing institution?

I am reading your statement here. I apologize for the fact that I got here a little late.

Mr. VOLCKER. The language in the law or the proposed law gives two alternative grounds: that it is deemed to have no real possibility of raising capital through viable standards or that there is no reasonable prospect that it can be self-funding.

Senator DIXON. Do you make that determination?

DETERMINATION MADE BY CHARTERING AUTHORITY

Mr. VOLCKER. We would not make the determination. In either case the determination would be made by the chartering authority.

The only way the Federal Reserve would get involved is that we might typically be lending to these institutions, and we might have some opinion as to their ability to fund themselves which we could convey to the chartering authority. But the power to make the determination goes to the chartering authority, which we would not be. It would be either the Comptroller or the State supervisor.

Senator DIXON. If you made a determination that an institution is failing, then the steps can unfold for a merger with an out-of-State institution, is that correct?

Mr. VOLCKER. Correct.

Senator DIXON. And you indicate here in your statement that I have been reading that there will be consultation with State authorities in that regard.

You would contact, I take it, Bill Harris, the commissioner of financial institutions in our State. What would his input into that be?

Mr. VOLCKER. The procedure is somewhat different, depending on whether it has FDIC assistance or not. If it did not have FDIC assistance and the bank itself explored the possibility of an out-of-State merger, we have to keep the supervisor informed.

When the application reached us—let's hypothesize that the bank advised us that it had an out-of-State acquirer, it is failing—we would notify the State banking supervisor. The supervisor would have at least 48 hours to enter agreement, objection, or whatever. Presumably he would be knowledgeable about this before because the bank would have informed him or we would have informed him informally, or perhaps the FDIC or the chartering authority.

So he would have had notice before that. Then he would have at least 48 hours—maybe more, but at least 48 hours—to say, "Look, I have got an in-State solution," and that in-State solution would have to be adopted as long as it is, in fact, a viable in-State solution.

Senator DIXON. Who makes that determination?

Mr. VOLCKER. We would, in the end, make the determination as to whether that were viable, using the normal standards that we have for approving any merger.

Senator DIXON. In the final analysis, what would happen in my State, as an example, would be that you would make the ultimate determination about whether there was a merger within our State that was adequate to meet your guidelines, as distinguished from an interstate purchase.

Mr. VOLCKER. That is correct, but if there was an interstate solution that was financially viable, we would have to approve that.

Senator DIXON. But the determination on viability would be yours.

Mr. VOLCKER. The ultimate determination on viability would be ours.

Senator DIXON. I guess I share the concern expressed by my friend from Washington. As you know, Mr. Chairman, in my State, for instance, I went to the Illinois House, believe it or not, in January 1951. My colleague, Representative Rostenkowski went there in January 1953. He's now chairman of the Ways and Means Committee. Senator Simon came there in January 1955. All of us lived through an experience in our State where, for over three decades, no approaching four, the main concern in our States has been this whole question of branch banking.

Now you are asking us, at the Federal level, to impose, as I see it, a form of branching on my State that institutionally any number of legislatures, for decades, have rejected. What is your response to that?

Mr. VOLCKER. We are not imposing any form of branch banking or holding company organization, or whatever. We are saying that, if in a particular State—say, theoretically, Illinois—that the stability of that banking system in that State were jeopardized, we provide a little room here for an out-of-State acquisition for a particular bank that either failed or was failing, if it met these other criteria and there were no in-State solutions.

So there is a little room provided for, in effect, overriding the State law in that very limited set of circumstances, but it is a very limited set of circumstances.

Senator DIXON. Have you considered the possibility of, at least in the case of the situation where the State offers an alternative, that the State certifies is adequate, of letting that final determination be made at the State level rather than by your office?

Mr. VOLCKER. We considered it, and obviously, all deference would be paid to that opinion. We would try to accommodate the in-State solution. I am now talking about the non-FDIC assisted transaction. Ultimately we feel that under existing law, and properly, as the supervisor of holding companies, we can't evade the responsibility. We really can't utimately turn it over to the State and say that it is going to make a determination as to the viability of the merger; however, the whole thrust of this legislation is to give whatever deference we can to whatever the State supervisor is able to come up with in the way of a viable in-State solution. We can't really abdicate that.

Senator DIXON. Did I notice in your statement that there is a 5-year sunset provision?

Mr. VOLCKER. Yes.

Senator DIXON. I thank the Chair.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman. I don't need to ask a lot of questions, since I am already convinced of the merits of the emergency acquisitions amendments. It is amazing how problems in your own backyard have a way of clearing one's vision. [Laughter.]

Let me say, not knowing whether this committee is going to legislate, it makes me feel good to know that the three individuals who are running the regulatory agencies of the country, probably as a group, are the best who have ever been in these positions. And I just want to say to each of these men that I appreciate your good work and your competency. I have thoroughly enjoyed working with you in this bill. I am hopeful that we will be able to work out a compromise that can be adopted. I hear concerns from local banks. I have not come out in favor of nationwide banking, but I do believe that given the crisis we face in Texas, Oklahoma, Louisiana, the Midwest and other parts of the country due to agriculture, that there is a big difference between letting a bank go bankrupt and allowing an acquisition that prevents that from happening. This would be the case in terms of the whole psychology of the business community, in terms of the impact on the FDIC, and in terms of the whole business climate of a portion of the country.

I firmly believe these emergencies acquisition amendments will make a great deal of difference. I understand that my colleague, Senator D'Amato from New York, has already used my good line about practicing medicine before the patient is dead rather than trying unsuccessfully later to bring him back to life. That's the problem with good lines. They get stolen. [Laughter.]

INVOLVEMENT OF STATE COMMISSIONERS

But in any case, it is high praise from someone as clever as my colleague from New York, to have him use my lines. I simply repeat them.

Let me ask a two-part question. As the bill is currently structured, the State banking commissioner has a great deal of influence and authority until the FDIC is actually putting money into the bank. It seems to me that that is an eminently reasonable approach. If we decided to go further, for example, to give the State banking commissioner a veto in those cases where the FDIC was not a participant, at least looking potentially at a sale involving a bank that is in the process of failing, would this be acceptable? Further, if we set up a procedure where the first acquisition choice was required to go to an in-State purchaser, the second choice to a purchaser from a contiguous State, the third choice to a regional bank, if the involved State was part of a regional banking compact and keeping in mind that the FDIC was not yet losing money, would any of you have any objection to the State banking commissioner having these powers or that a priority criteria be established for making these acquisition decisions?

Mr. **VOLCKER**. Let me say, if I may, Senator, that if a State is in a regional compact, banks within that region would already have a preference. They would become like an in-State bank. That would be consistent with current State law. It gets complicated to set up these priority things, and, if you go beyond that, it bears upon, perhaps, the number of bids that you are going to get or the viability of those bids. With that caveat, I don't have any problem with trying to work on a priority system, but it is a complication.

I think I do have a problem, ultimately, if the State bank supervisor, in effect, approved the merger. I think he's got a virtual veto now, if it's a viable merger. But giving the State bank supervisor the authority to approve the merger—and really, that includes the problem of supervising that holding company afterward—I don't think is a proper administrative or legislative procedure.

Senator **GRAMM**. Does anyone else want to add to that?

Mr. **CLARKE**. I would concur.

Mr. **SEIDMAN**. I would concur.

Senator **GRAMM**. One of the problems we have, of course, is that we are all concerned about creating the impression that the situation is deteriorating to a critical stage, and thereby contributing to the very problem wtih which we are trying to deal. I personally believe that the Texas banking system will survive and prosper, no matter what we do. My specific concern, however, is that by denying Texas banks access to out-of-State capital, that we will create a bank capital shortage in the State and prolong existing and anticipated economic difficulties. But I guess the only answer to the question that has been raised earlier about how can we make these decisions, when you cannot give us definitive proprietary data on how bad the problem may or may not be, ultimately boils down your ability to assess problems and our ability to have confidence in your capacity to resolve those problems.

And rather than asking a final question, let me just say that I have that confidence, and I hope that confidence is ultimately shared by my colleagues, and I further hope we can move ahead with a bill that I believe is well-structured. The bill is well thought out. I think there should and will be certain changes as we write it, but I believe as a basic structure it is a reasonable approach to a very difficult and potentially expensive problem.

Mr. **VOLCKER**. If I may just make one comment on your observations, Senator Gramm. I appreciate the confidence in the regulators collectively, but I think you have one additional protection. There are tough tests in this bill as to when the powers can actually be used. If there is no problem, the bill would never be used. And it would not be any incursion on State authorities at that point. When the bill is actually used, there would clearly have to be a demonstration of the urgency of the problem for a particular institution.

Senator **GRAMM**. Thank you, Mr. Chairman.

The **Chairman**. Senator Gramm, I note to my colleagues the clock is indicating a vote, but the clock is wrong. We are not having a vote on the floor. Senator Sasser.

Senator **Sasser**. No questions at this point, Mr. Chairman.

POOL OF POTENTIAL PURCHASERS

The **Chairman**. Mr. Chairman, the passage of S. 2372 will obviously greatly increase the pool of potentially purchasers of problem or failed banks. Will the regulators' proposal allow, or if it does not, would you advocate that other nonbank financial institutions be part of the bidding process? In other words, would insurance companies and securities firms, under limited circumstances, be allowed to become bidding parties?

Mr. **Volcker**. I would doubt it, if they are not part of a company that could become a bank holding company now.

The **Chairman**. Any difference of opinion with the other regulators?

Mr. **Clarke**. No, sir, I would agree.

The **Chairman**. Chairman Volcker, you stated in your testimony that the debate on the proposed legislation appears to center much less on questions of basic purpose and rationale, which seem to be broadly accepted, but on appropriate specific limitations designed to protect the rights of States. Now at the meetings we've held over the last few weeks and so on, I would certainly agree with that, and you've heard differing opinions here on the committee. Some who are very cautious and some who would tend to oppose, like Senator Gramm, who are strongly in favor. But it appears to me that if the legislation has any chance of passing, you are correct, nobody wants institutions to fail out there and create a panic, you must address the protection of States' rights.

I would assume we are going to have to reach some compromise.

Do you have any recommendations or suggestions, where we may look at those protections? You've all testified that you think they are adequate, and I don't doubt your sincerity or the fact you think they are adequate, but I have just as sincere opinions on this side of the table from those who don't.

Mr. **Volcker**. My first response would be that we've already made those compromises in proposing the bill and providing protections that we think balance the two interests.

Senator D'Amato thinks that was a political judgment that maybe was illicit on our part. I suppose it was a political judgment, but we attempted to balance the interests.

Two areas I might mention. The first Mr. Seidman mentioned in his opening statement. We reduced the limit here from $500 to $250 million. There are alternative ways of covering banks or bank holding companies that might be at issue here, and you could pick up on the suggestions that some have made for taking the top *x* number of banks, and I would add holding companies. That is the essential problem here in some of these unit banking States. You could take the 10 largest banks or holding companies in a particular State as an alternative measure of eligibility to the present $500 million. That is one area that could be looked at.

This question that Senator Gramm raises about priorities of out-of-State bidders, I am reluctant to deal with, because I think it is extremely complicated, but it is an area that could be looked at.

I would note in that connection that the Oklahoma Legislature, in acting, did look at that question and specifically rejected the idea of special preference for contiguous States for fear that they wouldn't get enough bidders, and that that would complicate the bidding process and detract from the usefulness of the legislation.

We've got to balance all these considerations, so that in fact, you will end up with some bidders. These banks or holding companies are not necessarily the most attractive proposition in the world, depending on particular circumstances, particular location, or whatever, even for an out-of-State bank.

REASONS FOR THE $250 MILLION THRESHOLD

The CHAIRMAN. You mentioned that the reduction from $500 to $250 million is a threshold. There are some who would say, well, you are creating a few more you can deal with by lowering that. But some would suggest there is a rationale for eliminating the threshold all together and simply say, if there is a troubled institution, we want to enlarge that pool of potential bidders. So why $250 million?

Mr. VOLCKER. That suggestion has certainly been made by some, particularly looking at some agricultural States that are characterized by small banks and by the prospect that in some areas in-State, as well as out-of-State bidders are in very short supply, even though the banks are very small.

I think you simply have to balance that logic against whether it is really necessary to go that far in terms of protecting the ability of States to determine their banking structures. The smaller the bank gets, the more likely you are to be able to find an in-State bidder, and the less likely you are to have systemic problems.

So $250 million is obviously an arbitrary number. From the standpoint of full assurance of stability, you would eliminate the number, but from the standpoint of protecting the States, you keep the number or you put it higher, and this is clearly a compromise that we arrived at in proposing the legislation.

The CHAIRMAN. Mr. Clarke.

Mr. CLARKE. Mr. Chairman, it just seems to me that that underscores what I indicated in my opening statement, that this is not an attempt to try to get in the backdoor with interstate banking. This is solely an attempt to provide supervisors an adequate tool to deal with what we call failure management.

Certainly, there are some strong arguments for lowering the threshold below the $250 million level. All you have to do is look at the size of the banks that are on our problem bank list. That in itself makes a very compelling argument that the size limit be lowered.

A number of people have also objected to the notion of an acquiror's being able to purchase all the units of a holding company. They believe that only the failing units of a holding company should be acquired. That is a very reasonable suggestion except for the fact that the holding company may not be of a large enough critical mass to survive. It is very difficult to make such a determination other than leaving it up to the Fed, which has jurisdiction over bank holding companies. If a mechanism can be devised for ensuring that the remaining holding company can survive, then perhaps some consideration can be given to allowing the acquisition of only the failing institutions in a holding company. But I can tell you from personal experience, the inability to deal with a holding company as a whole can under certain circumstances create a very difficult situation for bank supervisors.

The CHAIRMAN. Chairman Volcker, I concur with your response to a question earlier as to why we had such a high level of concern here in Washington when some of the State legislatures didn't. Maybe we viewed it from a different perspective, I am playing the devil's advocate here because I don't share the concerns of some of my colleagues that this is some great opening to interstate banking. But nevertheless, it is true that the energy bank problems are confined to a few States.

If so, why are we proposing a national solution across the board if these States are not concerned enough, where they are dealing directly with the problems every day, to pass State legislation? If there are only three or four States that are directly involved, why shouldn't their legislatures be dealing with it?

Mr. VOLCKER. I would be delighted if they would, but they just may not act in a timely fashion. They may act after the event.

Take the situation in Ohio or Maryland in the thrift industry of the State-insured institutions. Institutionally, in that respect, I might have argued that those problems were lurking there all along and there was concern about it. There were very strong interests working against any change in the State insurance system or any other approach to those problems.

When the problem finally broke, the State legislatures did act, but you had 60, 70—whatever the number of institutions—closed in those States during this period.

That is precisely the kind of situation that we want to avoid. We want to act before the crisis rather than wait until the problem is so apparent that then the States would act. By then it is too late.

Mr. SEIDMAN. Mr. Chairman, I would like to comment on that.

FAILURE TO ACT COSTS EVERY STATE IN THE SYSTEM

Within the State there may be a number of different interests and economic forces at work, but the main result of a State not acting is to increase the loss to the FDIC and in effect ask all the other banks around the country to pay for their right to reduce the number of bidders.

So that when you look at the State, it may make the judgment that it wants to maintain its particular system if it can foist the costs off on someone else, and as a matter of fact that is what will happen if the State doesn't act. If the losses are much larger to the FDIC, the FDIC would not be able to rebate on premiums in the normal way, and the cost of the State's not acting would be paid for by the other banks in the country.

NONBANK BANK LOOPHOLE

The **Chairman**. Mr. Seidman, a recent national services publication reported that the Federal bank regulators believed that the nonbank bank loophole should be closed in conjunction with S. 2372. While that publication doesn't quote you directly, it outlines your concern with leaving the loophole open because potential buyers would prefer to set up a nonbank bank rather than buy a failing institution.

Could you comment on that?

Mr. **Seidman**. I saw that reference, Mr. Chairman. I do believe that the nonbank loophole should be closed in conjunction with an overall adjustment to bank powers. I think this particular bill before you is more urgent and ought to be dealt with by itself.

The **Chairman**. Mr. Clarke, what is your opinion about closing the nonbank bank loophole? Is it so urgent that we should do it quickly, or do you agree with your fellow regulators that it should be closed in a more comprehensive bill?

Mr. **Clarke**. Mr. Chairman, I agree that it should be part of a more comprehensive bill. I have said that several times.

The comment was made earlier that if it is important enough to get it done then it should be hooked onto the train that is leaving the station. I see this as a station with more than one track, and I fully expect—as you have indicated before—that there is going to be another train coming along right behind this one. It seems to me that is the appropriate place to deal with the nonbank bank issue, as well as a number of the others that are before us.

The **Chairman**. As I have said many times before, I have no objection to closing the nonbank bank loophole, if it is closed as it was in my comprehensive legislation of August 1984, going on 2 years ago. And you all know the story there. The House was not willing to go to conference even though we had an 89-to-5 vote on the Senate floor on that piece of legislation.

So my mind has not been changed. It should be part of an omnibus bill, and I know there are people there who don't necessarily like your legislation but to get the nonbank bank loophole, they would say it is all right with us.

While that may be all right with them, it is not all right with me. So nobody misunderstands, we are not going to have a separate regulators' bill if all that goes with it is the nonbank bank loophole closing because then you can just forget any sort of comprehensive legislation this year, plus, as long as the court moratorium stays on nonbank banks there is no great emergency out there in that area, in any event.

The Supreme Court decision was very narrow, talking about the Fed's ability to regulate in that area. It certainly did not open the door, as a lot of people thought, to a brand new flood of nonbank banks.

I hope that we can proceed on that and that everybody understands that while it may be important to close the nonbank bank loophole, to close it all by itself in my opinion creates far more problem than it solves in a financial services industry that is changing so rapidly.

Senator Sasser, do you have any questions at this point?

Senator SASSER. Yes, one or two, Mr. Chairman.

Some people are now suggesting that the recent rise in the price of oil from $11 to $15 a barrel means oil prices may have bottomed out.

I assume that, in monitoring these banks with large portfolios of energy loans which allegedly caused the problem they are in, you have made assumptions on the future prices of energy.

IMPACT OF OIL PRICES

What assumptions has each of you made with regard to the future price of oil? Do you want to comment on that first, Chairman Volcker?

Mr. VOLCKER. I don't think we have any specific assumptions as to the future price of oil. Obviously, we are not living in a vacuum. To take account of the market conditions, you have to have some basis on which you are evaluating the portfolio, but that is not written in concrete.

The fact that the price has gone way down introduces a strongly cautionary note in terms of what kind of assumptions you make, but we haven't got any assumption that is locked in concrete on that score. That can change very rapidly, depending upon the short-term fluctuations of market prices.

What we do know is that the price is way down and could go up again, I guess.

Senator SASSER. It's turned around and coming back up from $11 a barrel.

Mr. VOLCKER. That is correct. In evaluating a bank, we would not necessarily take the lowest price that has existed, nor would the bank itself at any particular period of time. But it does emphasize the risks involved in evaluating these portfolios.

Senator SASSER. Mr. Seidman, has the FDIC made any assumption regarding future oil prices? Do you think they are going to go down or go back up?

Mr. SEIDMAN. We don't predict the price of oil. We generally look at the bank's own assumptions of the oil prices upon which they are evaluating and setting up their reserves and try to determine whether under the current market conditions those appear reasonable.

Then we often look at alternative pricing to see what the effect would be, but it is a moving target. Therefore, each time we try to evaluate whether the bank itself is making a reasonable determination under current circumstances.

Senator SASSER. If I were in the market to try to acquire one of these banks, I would sure be trying to make some determinations about what is going to happen to future energy prices. That appears to me to be an elementary requirement of making a decision as to whether it is acquired and, if you acquire, what the bank would be worth.

Just let me follow on by saying one of the committee's traditional concerns is—the concern of many of us—of the risk of undue concentration of economic power in a small number of institutions.

This bill represents a major step toward interstate banking.

Are you satisfied that you are currently receiving, or will receive, bids from the highest possible range of bidders?

By that I mean if acquisition authority is going to be expanded, should the bidding process be expanded at the same time, and do you see any need to reach out and try to bring in some banks of intermediate size that don't have the history of acquisitions that some of the larger banks do?

Mr. SEIDMAN. Senator, we are currently working on that problem as the result of the State compacts and as a result of a number of States going to interstate banking through their own legislation. The number of potential bidders is very much higher than it has been, and we are working to develop a bidders list that will take into account many changes in the availability of bidders.

Senator SASSER. Does anybody else want to respond to that?

Mr. CLARKE. Senator, I would like to make a comment on your observation about the oil price situation.

I think all of us share with you the hope that the apparent stabilization of oil prices will mean that those areas of the country that are impacted by the rapid decline are themselves going to stabilize. But I see this legislation that the committee is considering as something broader than simply dealing with energy banks. There are also troubled agricultural banks out there and banks that are affected by adverse trends in the timber industry, et cetera.

REASONABLE TOOLS FOR ALL SITUATIONS

What we are trying to do is put ourselves in a position where we have some reasonable tools to deal with situations that may arise in States that do not at present permit out-of-State acquisitions.

I hope very much that the energy problem will go away. I think it will go away. That doesn't mean that there will not be occasions when we need to have the tools that we are asking you to provide us.

Mr. VOLCKER. If I may just add, Senator, the number of bidders you are going to get is going to depend upon the particular situation and the particular bank, its location, its size, its prospects. One of the problems is that in some cases there may not be one within the State and there may not be all that many outside the State. In other situations there may be a lot more.

Bidding should be as broad as possible, but that is not the same as saying that there are going to be a lot of bidders because of circumstances.

Senator SASSER. As I understand the purpose of the bill—and this will be my last question, Mr. Chairman—it was designed to make acquisitions more attractive, to encourage bidders, first by allowing the buyer to come in before the bank has failed, as I understand it, and second, by sweetening the pot with new powers and new branching authority.

Now, given that, frankly, I think it is a fair question as to whether an acquisition has to be improved by as much as the bill recommends in order to encourage acquisition of these troubled banks.

My point is this. If you are trying to make it more attractive to a bidder, it appears to me that if a bank holding company has two choices—one, to start a fresh, healthy nonbank bank or, two, to take over a failed or failing institution with a long history of problems—that it might prefer to open a fresh nonbank bank. Given that scenario, is the panel in agreement that the nonbank bank loophole should be closed?

Mr. CLARKE. Senator, may I comment on that?

I think that is a misconception that some people have. A nonbank bank by definition is a crippled institution. It does not exercise full banking powers. That is what makes it a nonbank bank.

It seems to me that if faced with the opportunity of expanding by being able to acquire one or more full service institutions in a market as opposed to starting from scratch with a bank that has at least one hand tied behind its back, the choice is clear. So I would disagree that the possibility of starting a nonbank bank is going to dissuade potential purchasers of failing banks. I said earlier that I hope the nonbank bank issue will be dealt with in the context of a comprehensive legislative package, but I don't think closing the loophole would enhance our ability to find acquirors for failing banks.

Senator SASSER. What does the FDIC say about that, Mr. Seidman?

Mr. SEIDMAN. Our view is generally in agreement with that. I don't know that there might not be some specific circumstances where there would be an institution that would find it more advantageous to use the nonbank bank if it were available, which it isn't at the moment.

There could be an instance where that would have an effect. I think it would be minor, and it doesn't really go to the heart of this bill, which deals with increasing the number of bidders who are banks and want to be full service banks and see an economic opportunity in that particular State.

Senator SASSER. Do you want to add anything to that, Mr. Chairman?

Mr. VOLCKER. I think I would generally agree with Mr. Seidman. At the margin it might affect some, but I don't think it would have a major impact right here.

The people say you can't do a nonbank bank, but you can. You can't do it through a Federal charter, but you can do it through a State charter. That is open at the moment, and I certainly think it is a matter of urgency that that be closed, primarily for other reasons, not because of its dilution of the bidding here, although at the margin it might affect that.

Senator SASSER. Thank you, gentlemen. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman and fellow members of the committee.

Let me try and fold some of these questions in. You may have already addressed them.

HEARING REQUIREMENTS

The first has to do—and I will ask it as one question—with sections 4 and 9 of the bill dealing with the notice of hearing requirements. Obviously, in doing away with section 4, the notice of hearing requirement in this particular matter in order to expedite it, the first question would have to do with judicial review, since notice of hearing has so much to do with judicial review.

How would you handle that or how would you envision that particular problem being handled? How wise is it to enforce that section 4(c)(8), that notice of hearing requirement? And, third, might it make some sense to have a postacquisition hearing in order to examine things—at least you will establish a record as to the wisdom of the acquisition—as a way of dealing with the problems? Has this been raised already?

Mr. VOLCKER. No, this hasn't arisen.

The notice of hearing requirements can already be expedited or waived in emergency situations involving failed or failing banks, with FDIC assistance and I guess otherwise.

The purpose of putting that particular provision in this bill, supplementing already existing provisions, as I understand it, is to take care of the holding company situation where you would be acquiring healthy banks theoretically.

TESTS WILL BE MORE DIFFICULT

Senator DODD. Aren't you going to make the test more difficult under the Bank Holding Company Act by doing away with this?

Mr. VOLCKER. I don't think this is just for the acquisitions involved under the authority of this bill. The only purpose of that provision is to extend what already exists in emergency situations to encompass an entire holding company—the units of an entire holding company, some of which may not be in an emergency situation, technically. Otherwise, we would be faced with the ability to waive the notice of hearings for a failing institution, for a failed institution, but now we have a holding company, which is a combination of failed, failing, and not failing.

This provision enables you to deal with that unit as a whole and, obviously, it is impractical not to have an expedited procedure for part of the holding company and one for the whole holding company, and it is just designed to take care of that.

Senator DODD. That is why I make this suggestion of possibly having some kind of postacquisition hearing.

Mr. VOLCKER. You can have some kind of a postacquisition review. Just offhand, I don't know quite how you would do it.

Senator DODD. Is there a problem with that?

Mr. VOLCKER. I don't know. You have a general problem, and I don't know what my counsel is thinking.

Senator DODD. They're all there shuddering. [Laughter.]

Mr. VOLCKER. I can imagine why they are shuddering.

Senator DODD. You can't see it, but I can.

Mr. VOLCKER. What this gets into, I don't know. You would have a general problem. You've got an open institution. You've got open banks, and in the application process, that would be a lot of confidential information reviewed, and I think any review process would have to take account of the fact that nobody is going to bid, if they are going to have to reveal all this information publicly. But if something could be done consistent with that requirement——

Senator DODD. That is what I meant.

Mr. **Volcker** [continuing]. So that the basic rationale of the Board—or in the case of the FDIC, the FDIC—was made explicit. In principle, I think that is conceivable.

Senator **Dodd**. Do either of you——

Mr. **Volcker**. I think we would ordinarily do that. You have the essence of this procedure, Senator, now, when we approve the transaction, we would have an order—the FDIC would, too—explaining why we did it and the rationale and the circumstances. What they would need beyond that, I am not quite sure.

The **Chairman**. Mr. Clarke, Mr. Seidman, would you like to comment on this?

Mr. **Seidman**. I haven't really addressed that question. I would be glad to comment on it.

Senator **Dodd**. I would appreciate it.

Mr. **Clarke**. If your review, after the fact, is undertaken with the expectation that the transaction could be undone for some reason, it seems to me that that creates an awful lot of uncertainty in everybody's mind.

Mr. **Volcker**. I assumed that was not the case. I don't think you could undo one of these transactions. Just technically, this doesn't affect section 4(c)(8). This is section 3, where you are combining banks with nonbanking activities, which is essentially at issue here.

Mr. **Clarke**. And I would assume that such transactions would be subject to judicial scrutiny, as at present.

Senator **Dodd**. I am not suggesting they're not, but it's always more difficult to get judicial review, when you have an absence of a hearing. That is the point. In terms of the hearing process, normally, you go back to the hearing record, when you get judicial review of an acquisition.

Mr. **Volcker**. We very seldom actually have hearings. On certain occasions, we have hearings, but I don't think that affects judicial review.

Senator **Dodd**. It doesn't affect it, except to the extent that the hearing record provides, certainly, the strongest evidence available for judicial review of those acquisitions. It's not the only evidence, obviously, but it is a strong piece of evidence. That was really all my point is.

The last one, just again. It may have been raised in the past. I think it has to some extent been listening to Senator Sasser. I should preface it by saying, I am very sympathetic to what you're trying to do here. I don't want to nitpick on this thing. I understand it is a serious problem, and unlike a decade ago when the bumper stickers read, "Let them freeze in the dark," there is a side of me, I suppose, that doesn't want to forget that. [Laughter.]

But nonetheless, I recognize the predicament, and obviously, this problem is not isolated in its effect, and so on.

TIMING OF INTERSTATE BANKING

Having said that—also, I think all three of you are aware of my own feelings about the timing of interstate banking, not the question of interstate banking, but the pace with which we proceed to deal with the issue and what this potentially imposes, in terms of the question, whether or not we are looking at some alternatives. I realize this is a very narrow tightrope we are walking on in this particular area. Then the question arises, obviously, in my mind, and I am sure in most others, as well. This may have been raised, but whether or not it is counterproductive.

I think we have talked about this already, informally, but the counterproductivity of declaring that something is a failing institution, the accounts, the outflow of them, and so forth. It's become a self-fulfilling prophecy, in a sense, where we become more of an architect of exacerbating the problem, not of containing the problem.

I don't know if there is an answer to that. I would love to hear it.

Mr. VOLCKER. I think what you typically might expect to happen is that the institution is not declared failing at an early stage. That would be the typical nature of the situation. A bank might feel itself in that position, potentially, so it goes around looking for a partner, in-State or out-of-State, at some point. Let's say it is out-of-State. He says, "I can't find an in-State partner. I do have an out-of-State partner." Obviously, the supervisors would have been working with this institution. It didn't have to be publicly declared failing at an early stage in the process. That is an incremental judgment over a period of time, and you have the situation—I think the nearest analogy, in a sense, was Seafirst, in Washington—where the bank, I suppose, was in a failing situation, but it had an out-of-State buyer. And the fact that it had an out-of-State buyer promised to provide some stability to the situation, stabilized the bank, even though it was known to be in difficult circumstances. And I would hope that is the way it works here.

Senator DODD. In that sense, how could you determine beforehand whether or not capital impairment could only be cured by emergencies?

Mr. VOLCKER. It could be out of a long period of working with the bank. He may be under an order, he may not be under an order, to seek out capital wherever he finds it. The combination of the condition of the bank, the earnings of the bank, and his inability to find capital, presumably, under supervisory pressure at that point, gives you the answer to the question.

Senator DODD. How anxious do you want to be looked, when you've got this sitting out there in front of you? What rationale is there, what motivation is there for someone really to examine alternatives to repair capital through means of a merger, when you've got this wonderful opportunity sitting out there? Why bother? Why not rush to this solution?

Mr. VOLCKER. Senator, that is typically a better solution for them.

What have you got here? You've got the possibility of going out of State only if there is no in-State solution at any price. Your other alternative is getting FDIC assistance and, at that point, the game is kind up for the stockholders.

Mr. SEIDMAN. I think that is the point, Senator. If they require assistance from us, then the stockholders, at least, and maybe even the management, will be out of the action, and in the alternative, we don't provide assistance, and any interstate transaction that qualifies is not a financial transaction as the absolute preference.

Senator DODD. I thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Dodd.

Gentlemen, we appreciate all three of you being here today to testify.

The hearings will continue tomorrow. The Banking Committee is adjourned.

[Whereupon, at 10:45 a.m., the hearing was adjourned, to reconvene at 11 a.m., Wednesday, May 14, 1986.]

THE FINANCIAL INSTITUTIONS EMERGENCY ACQUISITIONS AMENDMENTS OF 1986

WEDNESDAY, MAY 14, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 11 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Gorton, Mattingly, Gramm, Cranston, and Riegle.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today we will conclude the hearings on S. 2372, the Financial Institutions Emergency Acquisitions Amendments.

As explained by the regulators at yesterday's hearing, this proposal will give them additional flexibility to enable the bank supervisors to deal more effectively with weakened banks.

This morning we will hear from the Conference of State Bank Supervisors and the trade groups whose members will be affected by the enactment of this legislation, receive testimony from representatives of the American Bankers Association, the Independent Bankers Association of America, and the Association of Bank Holding Companies.

As I indicated yesterday, it is my intention that the regulators' proposal be made part of a comprehensive package which I will introduce in the near future. This suggestion is S. 2372, as well as the nonbank bank issue be dealt with, but in a manner that more realistically addresses the changes occurring in the marketplace, in terms of a comprehensive bill.

Before we begin, I would like to insert Senators D'Amato's and Dixon's statements for the record.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

This morning the committee continues its examination of legislation drafted and advocated by the administration and the Federal banking regulators that would facilitate emergency interstate acquisitions of failing banks and bank holding companies. S. 2372 expands the existing emergency powers presently provided under the Garn-St Germain Act. The bill would grant Federal regulators increased powers to determine when, where and how banks can make interstate acquisitions.

Essentially, the bill ratifies the concept of geographic deregulation or full interstate banking. However, certain provisions of the bill limit the ability of an acquiring institution to expand in the State where it has made an acquisition of a failing bank or bank holding company. I find this arbitrary limitation imposed on an acquiring institution one of the more troubling aspects of the bill.

The dire economic conditions confronting farm and energy banks that has supposedly compelled the regulators to endorse this proposal demonstrates the need for full interstate banking rather than a bill dealing only with emergency acquisitions. While I favor geographic deregulation, I was hoping it would not be in the form of deregulation by disaster. Although my colleagues may think it a radical notion, I think the crisis in the farm and energy banking sector could have been avoided if these institutions could have expanded into other areas of the country that are experiencing tremendous economic prosperity. Rather than encouraging healthy or marginally healthy institutions to acquire financially troubled banks or bank holding companies, it seems more logical to allow banking institutions to expand into more prosperous regions of the country where there is a demand for credit.

Therefore, while it may be necessary to grant the Federal regulators increased emergency powers, I think we should consider ways to anticipate and avert future emergencies that result due to the cyclical nature of the economy in certain regions of the country. The energency proposal is not a cure, it is only a stop-gap measure that will provide only temporary solutions that will ultimately be solved through full interstate banking.

I look forward to the testimony of this morning's witnesses and any suggestions they may have to improve S. 2372.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on S. 2372, the Financial Institutions Emergency Acquisitions Amendments of 1986.

As I stated yesterday, I believe that we should act to give the regulators some additional flexibility to handle the serious problems facing segments of the banking industry, particularly in the energy and agriculture area. However, I think it is important to ensure that this assistance is drawn as narrowly as possible, with a view toward ensuring that in-State solutions to problems are used whenever possible. The risk of substantial exposure to the FDIC fund needs to be addressed, but I think it is possible to handle this matter in a way that keeps that exposure within reasonable bounds while continuing a preference for in-State, rather than out of State, solutions.

We have a distinguished group of witnesses before the committee today. I am here to learn and I look forward to having the benefit of their analysis and recommendations of how best to address the problems we are facing.

Senator GARN. Gentlemen, we are happy to have you with us today, and Mr. Rideout, if you would like to begin.

Mr. Rideout is president and chief executive officer, Savannah Bank & Trust Co. of Savannah, GA, speaking on behalf of the American Bankers Association.

STATEMENT OF THOMAS P. RIDEOUT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SAVANNAH BANK & TRUST CO., SAVANNAH, GA, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. RIDEOUT. Thank you, Mr. Chairman. The subject of these hearings is very important. The outcome of your deliberations will affect the future of the banking industry, deposit insurance system, and our econony as a whole.

Because this subject is so important, we devoted a substantial amount of time to it at our recent banking leadership conference in April. As you know, Mr. Chairman, this is the largest and most broadly based policy advisory group our association has. Our leadership conference did benefit from the input of Chairman Seidman of the FDIC, who outlined the major aspects of the proposed legislation. We also heard from a panel of bankers representing the troubled agriculture and energy States that conceivably could be most affected by the proposals you are considering.

LAST 8 YEARS ARE A VERY VOLATILE PERIOD

During the past 8 years our economy has gone through a very volatile and difficult period. These years have taken a toll on our economy and the energy and agricultural sectors have been particularly hard hit, as you know. Because banks lend to almost all sectors of the economy, the condition of the banks is inevitably a reflection of these ups and downs. Regulators, with the support of the Congress have acted progressively in designing regulatory forbearance procedures which should help bankers and their customers in making adjustments to these often difficult conditions.

Our banking leadership conference participants saw the regulators' request as an issue calling for a careful balancing of one, the need for greater regulatory flexibility to deal with troubled institutions and, two, the ability of States to determine their own process, if any, for engaging in interstate banking.

After listening to FDIC Chairman Seidman and the banker panel presentation, our delegates determined that the regulators did need greater flexibility than that provided by the current provisions of title I of Garn-St Germain. We recognize that when implemented, the regulators' requested powers will hasten interstate banking in the affected States.

It is interesting to note that since the Supreme Court decision in *Northeast Bancorp,* interstate banking in various forms has been proceeding rapidly via State laws. Nevertheless, we recognize that this evolution in State laws may be neither timely enough nor sufficiently far reaching to give the regulators flexibility needed to resolve important troubled bank situations.

Our bankers feel it is a worthwhile goal for the regulators to have more flexibility in finding a purchaser for particular troubled banks and bank holding companies, for they are not only concerned with the long-term financial integrity of the FDIC insurance fund, they are also concerned about the potential negative impact of bank failures on the local and State economy and on other banks within the same State. Yet we would caution that in pursuing this goal, we would hope to minimize the impact on State banking laws to the greatest practicable extent.

I would now like to present our position regarding the proposed regulators bill. My comments break down into two basic components.

STATEMENT OF ABA BOARD

The first is a statement adopted by our board after a thorough review by our leadership conference, and the second consists of some observations on the regulators bill, as presented in its final form.

First, the statement of our ABA banking leadership conference, dated April 18.

> The Federal banking regulators have developed a proposal providing for additional regulatory authority for emergency acquisitions of failing financial institutions. The American Bankers Association, in light of current economic circumstances, sup-

ports legislation which would grant the regulators the additional authority they have requested.

The ABA also adopted the following additional policy positions, intended to refine the regulators' proposal:

1. The definition of a "failing bank," which would be eligible for emergency acquisition, should be strictly drawn.

2. Any emergency acquisitions under the expanded authority should be permitted only if the State banking regulator in the failing institution's home State does not object to the acquisitions.

3. While ABA supports a reduction in the threshold size of the institution to be acquired from $500 to $250 million, as requested by the regulators, ABA believes consideration should be given to reducing the threshold further under appropriate circumstances.

4. This expanded regulatory authority should be subject to a 3-year sunset provision.

The statement goes on to conclude:

> The ABA Banking Leadership Conference emphasized strongly that legislation is also needed to close the nonbank bank loophole, because the existence of the loophole undercuts the motivation to acquire failing banks.

Subsequent to adopting the above statement on April 18, we received the proposed legislative language submitted to the Congress by the regulators. We are pleased that many of the concerns of our leadership conference have been at least partially addressed. We do still have a few concerns, which I would now like to discuss.

First, as presented more fully in my written testimony, the definition of a "failing bank" needs to be modified.

Second, the provisions of Garn-St Germain regarding the role of the bank supervisor are kept in the proposed extension. These provisions state that in the event of a proposed interstate acquisition of a troubled bank, there shall be noticed too an opportunity for an objection by the State bank supervisor, and that if the State bank supervisor objects, the FDIC's board may exercise its authority only by unanimous vote.

We believe that in troubled bank situations, the interests of Federal and State supervisors in resolving the problem are largely the same, and that the State regulator has a unique understanding of his or her State. Therefore, our preference would be for as strong a role for the State supervisor as is practicable.

Third, the proposed legislation would lower the old $500 million limit of title I of Garn-St Germain to $250 million. We support this reduction and note that many of our bankers expressed the sentiment for reducing this level further. We suggest that this be considered under appropriate circumstances which may vary from State to State.

Additional formulas, such as allowing emergency interstate acquisitions of the largest three or five banks in the State, also deserve consideration.

Fourth, we prefer a 3-year sunset provision to the 5-year period specified in the proposed legislation.

Fifth, the legislation specifies that an out-of-State bank which acquires a bank through an emergency acquisition may acquire additional banks located in the three largest metropolitan areas in the State, provided that bank holding companies within the State are allowed to expand to the same extent.

While our leadership conference did not review this particular concept, our board of directors recognized that some form of expansion rights might be necessary for the FDIC to obtain helpful bids; however, our board felt that this concern must be balanced against the possibility of an out-of-State bank not affected by local economic problems acquiring a single bank through an emergency acquisition and then being in an extremely strong expansion position vis-a-vis other in-State banks which were still recovering from a severe downturn.

We feel that compromises can be fashioned to maintain competitive equity in such situations.

For example, the new entrant could be granted expansion rights after a reasonable phase-in period.

CLOSING THE NONBANK BANK LOOPHOLE

Finally, we note that the nonbank bank loophole has not been closed. The existence of this loophole will obviously undercut the efforts of the regulators to sell troubled institutions. The sooner this problem is dealt with, the better off we all will be.

In conclusion, I would say that questions of changes in interstate banking laws raise many difficult issues, which must be dealt with cautiously, but these issues must be balanced with the need for the regulators to have the tools they need to handle the difficult problems they face in dealing with troubled institutions.

The proposal you are considering is a good start toward the required balancing of delicate issues. We have some general concerns which have been dealt with partially in the proposed bill. We have tried to make some specific suggestions as to how our concerns could be further addressed, which we hope will be useful to this committee. It appears that this legislation may need to be enacted fairly quickly. Under current circumstances, it is our feeling that the regulators deserve our support.

Thank you.

[The complete prepared statement follows:]

are required by law to rebate a large part of any budget savings to these banks. Because the budgetary impact of the supervisory activities of the banking agencies is essentially nil, we urge the Committee to work toward providing an exemption from Gramm-Rudman-Hollings and OMB oversight for the agencies.

Finally, we note that the nonbank bank loophole has not been closed. The existence of this loophole will obviously undercut the efforts of the regulators to sell troubled institutions. The sooner this problem is dealt with, the better off we all will be.

Conclusions

Questions of changes in interstate banking laws raise many difficult issues which must be dealt with cautiously. But these issues must be balanced with the need for the regulators to have the tools they need to handle the difficult problems they face in dealing with troubled institutions. The regulators' proposal is a good start towards the required balancing of delicate issues. We have some general concerns which have been dealt with partially in the proposed bill. We have tried to make some specific suggestions as to how our concerns could be further addressed, which we hope will be useful to the Subcommittee. It appears that this legislation may need to be enacted fairly quickly. Under current circumstances it is our feeling that the regulators deserve our support.

The CHAIRMAN. Thank you, Mr. Rideout.

Next, Mr. Charles Doyle, chief executive officer of Gulf National Bank, Texas City, TX, on behalf of the Independent Bankers Association.

Before I turn to you, Mr. Doyle, however, Senator Mattingly is kicking me in the shins, and he wants to speak.

Senator MATTINGLY. I just want to at least welcome Mr. Tom Rideout here, who happens to be from Savannah, GA, as you all know.

Mr. RIDEOUT. Thank you, Senator Mattingly.

OPENING REMARKS OF SENATOR MATTINGLY

Senator MATTINGLY. I appreciate your comments. Obviously, Senator Garn is in much better physical shape than I am. That's why he made it back to the committee before I did. [Laughter.]

But I do want to tell the chairman, though, that I continue to remain concerned over the bill, S. 2372, the so-called regulators' bill, and that the reservations, I think, as it really pertains to the interstate banking provisions. I think we are all deeply concerned about that. I think we were pretty clear in 1984 of what the decision was that we made, not only in this committee but on the floor of the Senate in reference to that issue in trying to preserve the States' rights issue on banking.

I think that S. 2372 has a potential of reserving that policy—I know some may disagree with that—but not necessarily by an act of Congress but by legislative fiat.

So I think that whatever we do, that we must approach this problem very gingerly in the Congress with the full knowledge of what its ramifications might be.

So that is sort of the end of my speech, Mr. Chairman. I appreciate you letting me speak, and I am sorry I kicked you in the shins. [Laughter.]

I'm kidding. Thank you.

The CHAIRMAN. No, he really didn't. He just pulled my coat.

Mr. Doyle.

STATEMENT OF CHARLES T. DOYLE, CHIEF EXECUTIVE OFFICER, GULF NATIONAL BANK, TEXAS CITY, TX, ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. DOYLE. Mr. Chairman, I appreciate the opportunity to appear before your committee and present our views on the regulators' proposal to liberalize the emergency interstate override of State banking laws. If adopted without amendment, control of the banking industry will become vested in fewer and fewer hands and States will have little control over their own financial destiny.

Being born in Oklahoma and now a native of Texas where some of this regulation is targeted I feel privileged to be able to discuss the need for the bill.

CLEAN REGULATORS' BILL

Before I discuss the specifics of the bill, however, I must strongly emphasize our view that the issues of emergency interstate takeover and the nonbank bank loophole must be linked. The existence of the loophole is inconsistent with the aims of the emergency takeover provisions. Unless the loophole is closed, these potential acquirers will be able to open a new nonbank bank instead of buying a troubled institution. The nonbank bank option would permit an out-of-State bank to make a fresh start without the problems of loans and management that exist in the troubled bank.

Therefore Congress should not extend, much less liberalize the emergency authorities, unless it closes the nonbank bank loophole at the same time. The regulators have been quoted in the BNA that the nonbank bank loophole should be closed in conjunction with legislation to ease interstate sales of failed banks. Both Chairman Volcker and Chairman Seidman indicated it makes no sense to expand authority to arrange interstate purchases without closing the nonbank bank loophole. We feel that this action is imperative in order for us to support the bill.

The CHAIRMAN. I could stop you there, Mr. Doyle. I heard their testimony yesterday, and you are partially correct. They said, in terms of a comprehensive bill, not just linked to this.

Mr. DOYLE. Yes, sir.

The CHAIRMAN. I know what you are saying, but if I were listening——

Mr. DOYLE. They would like to have a clean regulator bill, I understand.

The CHAIRMAN. They would like a clean regulators' bill. They do want the nonbank bank loophole closed, but as part of a comprehensive bill.

Mr. DOYLE. Thank you.

To me, a key motivating factor in the regulators' proposal is the desire to save money for the insurance funds by increasing the number of buyers for these troubled institutions, and we can't argue with that. This is certainly a worthy goal; however, this should not be our only goal.

Diversity and separation of banking and commerce—the local control of financial power—has long been the cornerstone of this country's financial and political system. In fact, the deposit insurance funds were established to make it possible for thousands of local institutions to remain strong participants in the economic lives of their communities.

We urge the Congress to be sensitive to this goal as it considers proposals like the emergency takeover bill which would enormously increase the power of regulatory officials in Washington.

Until now, regulators have acted as if the only way to solve their problem and assist the insurance fund is to circumvent State laws. They have failed, in our opinion, to explore all of the other possible solutions, such as including off balance sheet items in the deposit base for assessment, assessing foreign deposits, or a general increase of assessments. Given the dramatic growth of the FDIC fund from around $13 billion in 1981 to nearly $19 billion today, I question whether raising the assessments would be necessary.

Therefore, Congress should closely question the need for the regulators' current proposals. To date, they have not made the case for some of their more dramatic proposals, such as lowering the threshold, including failing banks, and making bank holding companies eligible for interstate acquisition. The situation may not be as desperate as they suggest, and there are alternative solutions which they have not fully explored.

OPPOSED TO $250 MILLION THRESHOLD

While it is possible that some liberalization of the Garn-St Germain authorities may be necessary, the regulators' proposals go too far. We oppose the arbitrary dropping of the takeover threshold from $500 to $250 million. This change alone would nearly double the number of banks exposed to interstate takeover from just over 500 to just under 1,000. We have seen no facts that would justify this wholesale addition to the interstate auction block.

The Texas Banking Commissioner, Jim Sexton, said a week or so ago that the Douglas amendment wasn't for sale. We are suggesting that it shouldn't even be for rent unless there are strong restrictions protecting State banking laws.

When similar proposals were made last year, we indicated that if some liberalization became necessary, we preferred that Congress retain the $500 million threshold and provide an exemption for the four largest banks in those States with fewer than four banks over the threshold. This approach was acceptable to the then head of the FDIC. Under this proposal, there would be at least four banks in every State of the Union that could be acquired by an out-of-State organization if there were no in-State buyer. It would avoid the problem posed by a State where one of its largest banks is troubled and yet there are no in-State buyers large enough to take it over. However, its effect would be limited to States with very few or no banks that are now over the threshold. On the other hand, the regulators' blanket proposal would affect all States, even those where there are ample numbers of potential in-State acquirers.

The regulators testified yesterday that they could be flexible on this kind of solution since it addresses a key issue of whether there will be an in-State buyer large enough to acquire a failed bank. We hope your committee will accept or adopt some substitution in this area.

The regulators have also proposed that the interstate takeover be extended to banks in danger of closing. Current law applies only to closed banks, which provides a significant safeguard against using this authority in cases where it is not absolutely necessary.

If this safeguard is to be weakened in order to save money for FDIC, other protections must be added. The current regulators' proposal lacks such protections. It simply says that a bank or a bank holding company may be sold interstate if it is in danger of closing. Though the bill includes a definition of this phrase, it is unacceptably vague. At a minimum, Congress should set specific standards for determining that a bank is in danger of closing, making clear that a bank's capital must have fallen below 1 percent before it can be considered in danger of closing. Such objective standards become particularly important if there are disagreements between the regulators as to whether a bank is failing.

ROLE OF STATE OFFICIALS

Another important safeguard against overuse of the interstate takeover authority involves the role of State officials. We propose that any acquisition under the liberalized authority not take place unless the State banking regulator in the target bank's home State does not object. We also believe that the target State's Governor should certify that the problem cannot be handled within the State before Federal officials arrange an interstate takeover. Our dual banking system must be preserved even when we face a crisis that requires emergency takeover provisions by our Federal Deposit Insurance Corporation.

We also believe that stockholders and directors in failing banks should be discouraged from seeking an interstate solution to their problems. In those cases where there is little, if any, intrinsic value left in the bank, the only value to an out-of-State acquirer would be the interstate franchise right. Therefore, we recommend that stockholders who agree to sell their banks to an out-of-State buyer receive no compensation. When small banks fail, their stockholders take such a hit. If anyone gains from an acquisition under the bill it should be the FDIC insurance fund since the taxpayers are standing behind that fund.

Another way to encourage in-State solutions would be to permit in-State bidders to rebid if their initial bid falls within 20 percent or $20 million of the best bid in the initial round. Comparable figures under the existing law are 15 percent or $15 million.

One serious problem in the current bidding procedure is that under current authority, FDIC must conduct the process overnight or, at best, over a weekend. This does not give most medium-sized potential acquirers enough time to properly evaluate the failing bank and make a prudent bid. Money center banks, on the other hand, can well afford to take the risks, especially if they are bidding for a valuable interstate franchise. An in-State bidder cannot compete with an out-of-State bidder for the new market. This inequity should be addressed by giving the FDIC the conservatorship or bridge bank authority that it has requested. That would permit the agency to operate a bank for a limited period and allow for a more orderly process in the bidding procedure.

This committee should ask the FDIC for specific proposals to provide greater assistance to open institutions and to broaden the bidding process to include more banks. The FDIC should use its authority to stabilize a bank, to assist the stockholders to get more capital into the bank. That, essentially, is what they did with Continental. Why won't that work for a little bank as well as a big bank?

DOMINANCE OF THE MONEY CENTER BANKS

One feature of the operation of the emergency takeover law has been the dominance of the money center banks. Time after time, they have extended their reach by acquiring institutions, particularly thrifts, in key States. We recommend that any extension of the emergency provisions include concentration limits so that the very largest banking organizations will not be able to acquire even more dominance. This would permit the larger second tier of institutions to participate. These institutions are still rather large, but lack the market dominance enjoyed by the money center banks.

The regulators' bill also puts bank holding companies on the interstate auction block if at least 33 percent of a holding company's banks are in danger of closing and total $250 million or more. Current law applies only to individual banks. The regulators' proposal would expose almost 3,000 banks and over 500 holding companies to interstate takeover and provide out-of-State buyers with vehicles for dramatic expansion within target States. We oppose this proposal.

We believe that the advantages of selling parts of holding companies or bank subsidiaries in cases of troubled individual banks are compelling. A holding company's more valuable subsidiaries should be sold to raise capital for the holding company. This committee may well be aware of the recent precedent for this procedure when Chrysler Corp. sold its profitable tank division and used the capital to bolster its main auto manufacturing business. Chrysler did indeed shrink in size, but it was the price it paid for the Federal assistance.

If Congress is persuaded that it must expose holding companies to takeover, it should not adopt the very liberal tests provided in the regulators' bill. We remain unconvinced that the regulators' low asset tests are necessary or desirable. It may well be a case of the regulators asking for more than they ever hope to receive.

Finally, the bill would grant an out-of-State acquirer the same expansion rights as an in-State holding company would have in the target State's three largest metropolitan areas. This would undermine State banking laws, such as those in Texas, that limit expansion to holding companies. This provision completes the undercutting of State control imposed by the other provisions of the regulators' proposal. This is unnecessary and we hope that it will be eliminated.

We are also concerned about the provision in the current law which permits any company to buy a failing thrift. Though this authority has not been acknowledged as a major feature of the law, as long as it remains it is a threat to the separation of banking and commerce and inconsistent with closing the nonbank bank loophole. Our concern here is that a national firm, especially retail companies, will purchase existing banks or thrifts, transform them into nonbanks and begin accepting insured deposits nationwide. We hope this possibility can be eliminated by removing the "any company" language in the emergency takeover provisions and by closing the nonbank bank loophole.

Your consideration of the concerns of the independent banking community regarding S. 2372 are most appreciated and we appreciate the opportunity to present our views on this important matter facing our industry. Thank you.

[The complete prepared statement follows:]

STATEMENT

OF

THOMAS P. RIDEOUT

on behalf of the

AMERICAN BANKERS ASSOCIATION

on

EMERGENCY INTERSTATE ACQUISITIONS

before the

COMMITTEE ON BANKING

HOUSING AND URBAN AFFAIRS

of the

UNITED STATES SENATE

May 14, 1986

Mr. Chairman and members of the Subcommittee, I am Thomas P. Rideout, President and Chief Executive Officer of the Savannah Bank and Trust Company, Savannah, Georgia. I am also Treasurer of the American Bankers Association and a member of its Board of Directors. Our Association is the largest national banking trade association and its members include banks of all size, type, and location. We are pleased to give you our views on the subject of emergency interstate acquisition of failed or failing banking institutions.

The subject of these hearings is very important. The outcome of your deliberations will be important for the future of the banking industry, its deposit insurance system, and our economy as a whole.

Because this subject is so important, we devoted a substantial amount of time to it at our recent Banking Leadership Conference. As you may know, Mr. Chairman, this is the largest and most broadly based policy advisory group our Association has. It consists of 430 bankers, and is comprised of our Board of Directors, our Government Relations Council, elected delegates to the Conference, the heads of staff and elected officers of the major national banking trade associations, the fifty state bankers associations, and the bankers associations of the District of Columbia and Puerto Rico. This group meets from time to time to discuss issues of major importance to our industry and to give recommendations to our Board of Directors, which then formulates our policy positions.

Although our Leadership Conference did not have the benefit of the precise proposed legislative language which was subsequently submitted to Congress, we did have knowledge of the general proposals that were to be incorporated in the proposed language. We also benefitted from the input of Chairman Seidman of the FDIC and a presentation by a panel of bankers from the troubled agriculture and energy states that conceivably could be most affected by the proposals you are considering. The Conference participants than held extensive discussions and came to several conclusions.

The legislative proposals being considered here today involve a balancing of hard choices. In the past eight years our economy has gone through a very difficult adjustment period. We have experienced: first strong inflation and double digit interest rates; then substantial disinflation and a steep recession, and now a resumption of more moderate, stable growth. This volatility has taken its toll on our economy, and certain sectors have been hurt more than others. Because banks lend to almost all sectors of the economy, the condition of banking is, inevitably, a reflection of these ups and downs.

Two areas that have been particularly hard hit are energy and agriculture. Farmers are struggling hard to overcome the effects of disinflation on land prices and the new realities of a competitive world marketplace for their products. Energy producers are only beginning to struggle with the breakup of the OPEC oil cartel. Agriculture and energy banks are working hard to maintain their profitability so that they can have the capacity to work with their customers through this difficult adjustment period. Regulators, with the support of the Congress, have acted progressively in designing regulatory forbearance procedures which should help bankers and their customers in making those difficult adjustments.

The participants in our Banking Leadership Conference saw the issue before the Subcommittee today as one calling for a careful balancing of the need for greater regulatory flexibility to deal with troubled institutions with the ability of states to determine their own process, if any, for engaging in interstate banking. After listening to FDIC Chairman Seidman

and bankers in agricultural and energy states, our bankers determined that the regulators did need greater flexibility than that provided by the current provisions of Title I of Garn-St Germain.

Such flexibility, if implemented, will hasten interstate banking in the affected states. It is interesting to note that, since the Supreme Court decision in Northeast Bancorp, interstate banking, in various forms, has been proceeding rapidly via state laws. We estimate that by the end of this year over two-thirds of the states will have enacted some type of interstate legislation. Nevertheless, we recognize that this evolution in state laws may not give the regulators the flexibility needed to resolve important troubled bank situations.

Our bankers were concerned that, without this additional flexibility, the regulators might find it difficult, or even impossible, to find a purchaser for troubled banking institutions. If the regulators were unable to find a purchaser, they might be forced to resolve a bank failure in a manner which has a negative impact on the local and state-wide economy, as well as on other banks within the same state. It should also be noted that such a result would have a negative impact on the FDIC insurance fund. We have a strong FDIC fund, and we wish to keep it that way. Furthermore, as the fund is forced to use more of its resources to deal with troubled institutions, bank assessment rebates may be scaled back, lowering bank profits and potentially slowing capital buildup in banks. We believe the regulators should, in general, have the flexibility they need to avoid such results. We might wish that there were better alternatives; but realistically, there do not appear to be any.

Nevertheless, we do have some suggestions as to how the regulators' proposal might be fine-tuned to limit its impact on the various state banking laws without inhibiting bids from potential acquirers when they are needed. But first let me present our position. Again, this position was adopted by our Board before the regulators' bill in its final form was developed.

April 18, 1986, Statement
of the ABA Banking Leadership Conference

> The federal banking regulators have developed a proposal providing for additional regulatory authority for emergency acquisitions of failing financial institutions. The American Bankers Association, in light of current economic circumstances, supports legislation which would grant the regulators the additional authority they have requested.
>
> The ABA also adopted the following additional policy positions, intended to refine the regulators' proposal:
>
> 1. The definition of a "failing bank" (which would be eligible for emergency acquisition) should be strictly drawn.
> 2. Any emergency acquisitions under the expanded authority should be permitted only if the state banking regulator in the failing institution's home state does not object to the acquisitions.
> 3. While ABA supports a reduction in the threshold size of the institution to be acquired from $500 million to $250 million, as requested by the regulators, ABA believes consideration should be given to reducing the threshold further under appropriate circumstances.
> 4. This expanded regulatory authority should be subject to a three-year sunset provision.
>
> The ABA Banking Leadership Conference emphasized strongly that legislation is also needed to close the nonbank bank loophole because the existence of the loophole undercuts the motivation to acquire failing banks.

Subsequent to this April 18 meeting we received the proposed legislative language submitted to Congress by the regulators. We are pleased to see that most of the concerns of our Banking Leadership Conference have been at least partially addressed in the proposed legislative language. We do still have a few concerns which I would now like to address.

The proposed legislative language lists three criteria to be used to determine if a bank is in danger of closing:

1. the bank is not likely to be able to meet the demands of its depositors or pay its obligations in the normal course and there is no reasonable prospect for it to do so without federal assistance; or
2. the bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital and there is no reasonable prospect for replenishment of the bank's capital without federal assistance; or
3. other grounds exist or are likely to exist under state law for closing the bank.

The term "federal assistance" is not defined. We suggest substituting "potential losses to the FDIC." One thing this substitution would do is prevent the confusion of assistance from the FDIC with assistance from the Federal Reserve through its discount window.

It is conceivable that a bank could be fundamentally solvent but, because of panic conditions in financial markets, be unable to meet the demands of its depositors or pay its obligations. This is the classic definition of a liquidity crisis which the Federal Reserve's discount facility was designed to stem. The proper remedy is to use the discount window, not to have an interstate merger.

With the proper language substituted for "federal assistance" in criterion 2, this criterion seems to us to be a sensible definition of a bank that is in danger of failing. With this definition, the first criterion would not appear to be needed.

The third criterion is overly vague, and its meaning is difficult to discern. In any case, with the change we have suggested this criterion would also seem to be unnecessary. If a state law could force a bank closure such that the FDIC incurred losses, then an interstate merger could be arranged under criterion 2 if necessary. If a state law could force a closure in which the FDIC would not incur losses, there is no need for an interstate merger.

The provisions of Garn-St Germain regarding the role of the bank supervisor are kept in the proposed extension. These provisions state that in the event of a proposed interstate acquisition of a troubled bank, there shall be notice to and opportunity for objection by the State bank supervisor (whether the bank has a state or Federal charter); and if the State bank supervisor objects, the FDIC's Board of Directors may exercise its authority only by unanimous vote.

We believe that in troubled bank situations the interests of Federal and State supervisors in resolving the problem are largely the same and that the state regulator has a unique understanding of his or her state. Therefore our preference would be for as strong a role for the state supervisor as is practicable.

The proposed legislation would lower the old $500 million limit of Title I of Garn-St Germain to $250 million. We support this reduction and note that at our recent Banking Leadership Conference there was significant sentiment for reducing this level further. We suggest that this be considered under appropriate circumstances. Additional formulas, such as allowing emergency interstate acquisitions of the largest three or five banks in a state also deserve consideration.

We prefer a three year sunset provision to the five year period specified in the proposed legislation.

The proposed legislation specifies that an out of state bank which acquires a bank through an emergency acquisition may acquire additional banks located in the three largest metropolitan areas in the state, provided that bank holding companies within the state are allowed to expand to the same extent. At the time of our consideration of this legislation at our Leadership Conference, no such provision was in the regulators' proposal. Nevertheless, our Board of Directors recognized that some form of expansion rights within the state might have to be granted in order for the FDIC to obtain the necessary bids. However, they felt that this concern needed to be balanced against the possibility that an out of state bank, not subject to the economic problems that affected large numbers of instate banks, could acquire a single bank through an emergency acquisition and then be in an extremely strong acquisition position vis-a-vis other instate banks. In other words, the new entrant might be able to move quickly to acquire other banks while the instate institutions are still recovering from the economic downturn. Because our Board of Directors did not have a chance to consider the specific provision in the regulators' bill, we have not developed a detailed position. However, if a compromise is needed to attract sufficient bidders, there would seem to be a number of other alternatives the Congress might wish to consider. For example, the new entrant could be granted expansion rights after a phase-in period.

We note that the banking agencies, in their efforts to identify and assist troubled banks, continue to be hampered by the artificial budgetary restrictions imposed by the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985. Moreover, the Office of Management and Budget has recently asserted vastly increased budget supervisory authority over these agencies.

While our Association is strongly in favor of measures to reduce the budget deficit, we think it senseless and counter productive to restrict the budgets of the banking agencies in the process. Not only are the entire budgets of the agencies paid by the banks they supervise, but the agencies this authority has not been acknowledged as a major feature of the law, as long as it remains, it is a threat to the separation of banking and commerce and inconsistent with closing the nonbank bank loophole. Our concern here is that national firms--especially retail companies--will purchase existing banks or thrifts, transform them into nonbank banks, and begin accepting insured deposits nationwide. We hope this possibility can be eliminated by removing the "any company" language in the emergency takeover provisions and by closing the nonbank bank loophole.

I hope these comments are helpful as you consider any further extension and modifications to the authorities of the Garn-St Germain Act. We, of course, look forward to working with you on these important matters.

The CHAIRMAN. Thank you, Mr. Doyle.

The next witness, Mr. John R. Petty, chairman and chief executive officer, Marine Midland Banks, Inc., New York, on behalf of the Association of Bank Holding Companies.

TESTIMONY

of

Charles T. Doyle
Chief Executive Officer
Gulf National Bank
Texas City, Texas

and

President

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

on

S. 2372

Before the
Committee on Banking, Housing and Urban Affairs
Honorable Jake Garn, Chairman

Washington, D.C.

May 14, 1986

My name is Charles T. Doyle and I am Chief Executive Officer of the Gulf National Bank in Texas City, Texas. I am also President of the Independent Bankers Association of America. IBAA is the national trade association of community banks, representing some 7,000 small and medium-sized banks throughout the United States.

Mr. Chairman, I appreciate the opportunity to appear before your Committee and present our views on the regulators' dramatically liberalized emergency interstate takeover proposals. If they are adopted, control of the banking industry will become vested in fewer and fewer hands and states will have little control over their own financial destiny.

THE NONBANK BANK LOOPHOLE

Before I discuss the specifics of the regulators' bill, I must strongly emphasize our view that the issues of emergency interstate takeovers and the nonbank bank loophole must be linked. The existence of the loophole is inconsistent with the aims of the emergency takeover provisions; unless the loophole is closed, potential acquirers will be able to open up a brand new nonbank bank instead of buying a troubled institution. The nonbank bank option would permit the out-of-state bank to make a fresh start without the problem loan and management difficulties left over in the troubled bank. If this is true, the market for troubled institutions could dry up. Therefore, Congress should not extend, much less liberalize, the emergency authorities unless it closes the nonbank bank loophole at the same time.

I would like to emphasize at this point that our concerns over the nonbank bank loophole are aimed directly at the safety and soundness of our banking system. Frankly, I get tired of hearing the banking community unfairly maligned by those who say that we oppose nonbank banks out of parochial self-interest or that we have our "heads in the sand" about changes in the marketplace.

The independent bankers of this country are deeply and sincerely committed to preserving competition in the marketplace. For example, I believe that our association's new credit card program will increase competition in that market. And we support Senator Dodd's bill to require earlier disclosure of credit card fees and rates since timely information is vital to a competitive market.

However, nonbank banks will do little, if anything to increase competition. This is a great myth. If anything, these so-called "consumer" banks are misnamed. What we are really talking about in many cases are deposit-skimming operations. By definition, a nonbank bank that takes demand deposits cannot make commercial loans--to the detriment of small business in particular. And, the consumer they seek to serve is the upscale consumer--they want to skim off this deposit base.

These new, specialized institutions would undermine the existing financial institutions' structure to the detriment of the full range of customers they serve and to the eventual detriment of the insurance funds. The nonbank bank loophole says that any kind of firm may own a bank. Our concern is that risks inherent in the wide range of commercial enterprises will eventually affect federally-insured nonbank banks. To prevent this, our bank examination force will have to become experts in virtually every form of commercial enterprise, or rely on the hope that every nonbank bank owner's business will never fail.

We think that anyone who owns a bank has to fulfill the responsibilities of owning a bank. They are given certain privileges, one of which is the safety net provided by the taxpayers of this country. We feel they must meet the terms and conditions set forth by Congress regarding what is a bank, who can own a bank, and where a bank may operate.

We also find it contradictory that this Administration, which has been so committed to doing away with specialized institutions, is at the forefront of promoting a new kind of specialized institution.

The Administration has said it will only support closing the loophole if banks are given new competitive powers and ordinary commercial firms are given the right to buy thrifts. The idea behind this stance is that there are unmet consumer needs that must be addressed either by leaving the nonbank bank loophole open or letting any sort of company own federally-insured thrifts.

This ignores two crucial considerations. First, there are already over 14,000 commercial banks, 3,300 savings and loans, and nearly 20,000 credit unions already providing competitive services in the marketplace. The consumer is hardly underserved. Second, the risks of leaving the loophole open far outweigh whatever consumer benefits might be derived.

THE REGULATORS' BILL

A key motivating factor in the regulators' proposals is a desire to save money for the insurance funds by increasing the number of buyers for troubled institutions. This is certainly a worthy goal. However, this should not be your only goal. Diversity, the separation of banking and commerce, and local control of financial power have long been cornerstones of the country's financial and political system. In fact, the deposit insurance funds were established to make it possible for thousands of local institutions to remain strong participants in the economic lives of their communities. We urge the Congress to be sensitive to this goal as it considers proposals like the emergency takeover bill which would enormously increase the power of regulatory officials in Washington.

Until now, the regulators' have acted as if the only way to solve their problems is to circumvent state laws. They have ignored other possible solutions, such as including off balance sheet items in the deposit base, including foreign deposits, or raising assessments. Given the dramatic growth in the FDIC fund--from around $13 billion in 1981 to nearly $19 billion today--I seriously doubt whether the last solution would be necessary.

Therefore, Congress should closely question the need for the regulators' current proposals. To date, they have not made the case for some of their more dramatic proposals, such as lowering the threshold, including failing banks, and making bank holding companies eligible for interstate acquisition. The situation may not be as desperate as they suggest, and there are alternative solutions which they have not fully explored.

The Threshold

While it is possible that some liberalization of the Garn-St Germain authorities may be necessary, the regulators' proposals go way too far. We oppose the arbitrary dropping of the takeover threshold from $500 to $250 million. This change alone would nearly double the number of banks exposed to interstate takeover from just over 500 to just under 1000. We have seen no facts that would justify this wholesale addition to the interstate auction block.

When similar proposals were made last year, we indicated that we preferred that Congress retain the $500 million threshold and provide an exemption for the four largest banks in those states with fewer than four banks over the threshold. This approach was acceptable to the then head of the FDIC. Under this proposal, there would be at least four banks in every state of the union that could be acquired by an out-of-state organization if there were no in-state buyer. It would avoid the problem posed by a state where one of its largest banks is troubled, and yet there is no in-state buyer large enough to take it over. However, its effect would be limited to states with very few, or no, banks over the threshold. On the other hand, the regulators' blanket proposal would affect all states, even those where there are ample numbers of potential in-state acquirers.

Chairman Volcker and Chairman Seidman testified last week that they could accept this kind of solution, since it addresses the key issue of whether there will be an in-state buyer large enough to acquire a failed bank. We hope your Committee will adopt the substitute provision we have suggested.

"In Danger of Closing"

The regulators have also proposed that the interstate takeover provisions be extended to banks "in danger of closing." Current law applies only to "closed" banks, which

provides a significant safeguard against using this authority in cases where it is not absolutely necessary.

If this safeguard is to be weakened in order to save money for the FDIC, other protections must be added. The current regulators' proposal lacks such protections. It simply says that a bank or bank holding company may be sold off interstate if it is "in danger of closing." Though the bill includes a definition of this phrase, it is unacceptably vague. At a minimum, Congress should set specific standards for determining that a bank is in danger of closing, making clear that a bank's capital must have fallen below one percent before it can be considered "in danger of closing." Such objective standards become particularly important if there are disagreements between the regulators as to whether a bank is "failing." And the regulators have been known to disagree.

Another important safeguard against overuse of the interstate takeover authority involves the role of state officials. We agree with the Conference of State Bank Supervisors and the American Bankers Association that any acquisition under the liberalized authority not take place unless the state banking regulator in the target bank's home state does not object. We also believe that the target state's governor should certify that the problem cannot be handled within the state before federal officials arrange an interstate takeover. These protections would help counterbalance the increase in the number of banks exposed to interstate takeover under the change in the size of banks eligible and the proposed addition of "failing" banks to those now covered. Our dual banking system must be preserved even when we face a crisis that requires emergency takeover provisions by our Federal Deposit Insurance Corporation.

We also believe that stockholders in failing banks should be discouraged from seeking an interstate solution to their problems. In those cases there is little, if any, intrinsic value left in the bank; the only value to an out-of-state acquirer would be the interstate franchise right. Therefore, we recommend that stockholders who agree to sell their banks to an out-of-state buyer receive no compensation. When small banks fail, their stockholders do take such a hit. If anyone gains from an acquisition under this bill it should be the FDIC, since the taxpayers are standing behind that fund.

Another way to encourage in-state solutions would be to permit in-state bidders to rebid if their initial bid falls within 20% or $20 million of the best bid in the initial round. Comparable figures under current law are 15% and $15 million.

One serious problem with the current bidding procedure is that under current authority the FDIC must conduct the process overnight, or, at best, over a weekend. This does not give most medium-sized potential acquirers enough time to properly

evaluate the failing bank and make a prudent bid. Money center banks, on the other hand, can well afford to take the risks, especially if they are bidding for a valuable interstate franchise. This inequity should be addressed by giving the FDIC the conservatorship, or bridge bank, authority that it has requested. That would permit the agency to operate a bank for a limited period and allow for a more orderly bidding procedure.

This Committee should ask the FDIC for specific proposals to provide greater assistance to open institutions (such as the conservatorships already utilized by the FSLIC) and to broaden the bidding process to include more banks. The FDIC should use its authority to stabilize a bank, to assist stockholders to get more capital into the bank. That, essentially, is what they did with Continental. Why won't that work with a little bank as well as a big bank? Why do we always have to provide that kind of help for a big bank and not for a little bank? This should be considered in tandem with this interstate legislation.

One feature of the operation of the emergency takeover law has been the dominance of the money center banks. Time after time they have extended their reach by acquiring institutions, particularly thrifts, in key states. We recommend that any extension of the emergency provisions include concentration limits so that the very largest banking organizations will not be able to acquire even more dominance. This would permit the large second tier of institutions to participate. These institutions are still rather large, but lack the market dominance enjoyed by the money center banks.

Holding Companies

The regulators' bill also puts bank holding companies on the interstate auction block if at least 33% of a holding company's banks are in danger of closing and total $250 million or more. Current law applies only to individual banks. The regulators' proposal would expose almost three thousand banks and over 500 holding companies to interstate takeover and provide out-of-state buyers with vehicles for dramatic expansion within target states. We oppose this proposal.

We do not believe that our concerns are outweighed by the difficulties of selling holding companies as individual parts. In fact, we believe that the advantages of selling parts of holding companies, or bank subsidiaries in cases of troubled individual banks, are compelling. A holding company's more valuable subsidiaries could be sold to raise capital for the company. This Committee is well aware of a recent precedent for this procedure when the Chrysler Corporation sold its profitable tank division and used the capital to bolster its main auto manufacturing business. Chrysler did indeed shrink, but that was the price it paid for its federal loan guarantee.

If Congress is persuaded that it must expose holding companies to takeover, it should not adopt the very liberal tests provided in the regulators' bill. We remain unconvinced that these low asset tests are necessary or desirable. It may well be a case of regulators asking for more than they ever hope to receive. Instead, if Congress approves the acquisition of holding companies, it should adopt the $500 million threshold and require that at least 65% of the holding company's bank assets have failed, rather than the 33% standard that the regulators have proposed. Of course, the safeguards we outlined earlier in this testimony should also apply in these cases.

Expansion Rights

Finally, the bill would grant an out-of-state acquirer the same expansion rights as an in-state holding company would have in the target state's three largest metropolitan areas. This would undermine state banking laws, such as those in Texas, that limit expansion to holding companies. This provision completes the undercutting of state control imposed by the other provisions of the regulators' proposal. This is unnecessary and we hope it will be eliminated.

Thrift Acquisitions

We are also concerned about the provision in current law which permits "any company" to buy a failing thrift. Though prohibited bank holding companies from operating such entitities, *because*--and only because--S. 2851 was a much broader bill. In addition to the regional banking sanction I mentioned above, S. 2851 also contained additional powers for bank holding companies, as well as procedural improvements in the Bank Holding Company Act. Our members continue to be unwilling to forfeit the geographic option offered by the "non-bank bank," limited as it is, without obtaining significant additional product and service powers, especially because the "grandfathering" date is far, far too generous, and S&L's would be exempted.

Conclusion

Mr. Chairman, we believe action on S. 2372 should not be delayed. Nor should the bill be encumbered with extraneous amendments. On the contrary, restrictions will inhibit the effectiveness of the bill in attracting bidders should the emergency provision be invoked. We take the regulators seriously--that problems do exist and that this bill is an appropriate tool to help them deal with those problems. Moreover, the basic innovation in S. 2372, to allow the acquisition of failing bank holding companies by out-of-state purchasers, dates back to a proposal considered by this Committee in 1975. S. 2372, therefore, is a far cry from a sudden or fundamental change in banking law. It is already too tightly drawn.

The **Chairman**. Thank you, Mr. Petty.

Next, Mr. John Malarkey, Delaware State Bank Commissioner, on behalf of the Conference of State Bank Supervisors.

STATEMENT OF JOHN MALARKEY, DELAWARE STATE BANK COMMISSIONER, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. **Malarkey**. Mr. Chairman and members of the committee, I'm John Malarkey, State bank commissioner for Delaware and president of the Conference of State Bank Supervisors [CSBS] on whose behalf I am testifying today.

At the outset, I would like to dispell three myths perpetuated at yesterday's hearing.

First, this is not emergency legislation. It is at best contingency legislation and, at worst, interstate legislation. The worst case I refer to is the unassisted interstate sale of an open bank with shareholder interest in place. That is nothing more, nothing less, than a violation of the Douglas amendment.

NO SAFEGUARD OF STATE INTERESTS

Second, there is no effective safeguard of State interests, no virtual State veto as you were told yesterday. In order to upset a proposed interstate transaction under this bill, the State must find someone to make the FDIC whole. If you accept that all transactions under this bill will be FDIC assisted and even on interstate transactions there will be costs to the fund, the supposed safeguard of the bill is meaningless. You will almost never find an in-State buyer to make the fund whole if the institution is truly in danger of closing. Yet the proposed legislation rejects the in-State assisted transaction as a viable alternative in spite of the fact that it has been effectively used to reduce costs to the fund. It is a funny war in which we adopt perpetual retreat rather than using ammunition, in which the insurance fund can spend no money to perpetuate the system it is designed to undergird.

Third, States have been responsive to the current situation to the extent and in the manner which they deemed to be appropriate. Believe me, the impact of a bank closing is most keenly felt at the State and local level. While you are protecting the fund, we are protecting our hides. A sweeping grant of authority to Federal agencies which includes preemption of State law is not my idea of assistance. We are willing to work with the agencies as we have done in the past and we will even assist in drafting contingency legislation, but we draw the line at helping to tie the knot for our own lynching.

My written testimony submitted for the record contains our case that the Federal agencies have not proven the need for the proposed legislation nor accounted for its serious disadvantages. In addition, in it you will find a list of eight safeguards which we feel would have to be included in contingency legislation. I would highlight just a few of these.

The definition of a failing bank eligible for emergency interstate acquisition should be strictly drawn. Any emergency acquisition under the expanded authority should be permitted only if the State banking regulator in the failing institution's home State does not object to the acquisition.

Stockholders in the failing bank should be required to agree to limit windfall profit taking in instances of interstate sale.

The threshold size of institutions eligible to be acquired should not be less than $500 million or one of the four largest banks in the State.

A meaningful preference for intrastate acquisition under which the FDIC need not be made 100-percent whole but may assist in intrastate transactions before peddling an institution interstate should be written into the bill.

SALE OF BANK HOLDING COMPANIES

In addition, CSBS feels strongly that the FDIC should not be allowed to sell an entire bank holding company as a package deal. Selling off profitable subsidiaries of a bank holding company separately as is current practice continues to make good business and policy sense. The possibility of parceling the assets of a bank holding company for offer intrastate so that something less than the entire bank holding company could be bid on would also help in this regard.

Finally, CSBS strongly believes that legislation is needed to close the nonbank bank loophole because the existence of the loophole undercuts the motivation to acquire problem institutions of any type.

Finally, I would like to insert a correction to my written testimony which has been previously submitted, Mr. Chairman. On page 8 there's a reference which starts off, "Mr. Chairman, as you have said." We seem to have had a computer error and I apologize for it. That statement should not have been in there.

Thank you, Mr. Chairman and members of the committee. I would be happy to answer any questions you might have.

[The complete prepared statement follows:]

STATEMENT OF JOHN R. PETTY, VICE CHAIRMAN, ASSOCIATION OF BANK HOLDING COMPANIES

Introduction

Mr. Chairman and members of the Committee, I am John R. Petty, Chairman of the Board and Chief Executive Officer of Marine Midland Banks, Inc. I am appearing before you today in my capacity as Vice Chairman of the Association of Bank Holding Companies. Accompanying me is John S. Rippey, Senior Vice President of the Association.

Our Association is composed of approximately 155 member companies, ranging in size from Mid-Continental Bancorporation, Inc., of Milwaukee, with assets of $165 million, to the largest in the country. Marine Midland, with assets of about $24 billion, is a blend of money-center activities and a diverse commercial and consumer business. In most respects, we are typical of the regional bank companies that make up our membership.

We appreciate the opportunity you have provided, Mr. Chairman, for the Association to comment on S. 2372, the "Financial Institutions Emergency Acquisition Amendments of 1986," sometimes called the "regulators' bill." The amendments extend and modify the authority Congress granted to federal banking agencies in 1982 to arrange interstate acquisitions and mergers of failed banks and savings and loan associations, and failing mutual savings banks. The principal purpose of the amendments is to engage the interest of out-of-state bidders with the financial and managerial resources to acquire

failing, or failed, bank holding companies. The authority now being requested by the federal bank regulatory agencies flows naturally from that given them by Congress in 1982 in the "Garn-St Germain Act."

We strongly support the need for the regulators' proposal; it is an appropriate extension of public policy. No new policy is made or intended: S. 2372 is merely a modification of an authority too narrowly defined previously, a precautionary enlargement. It is by no means watershed interstate banking legislation.

Background

It may be instructive to recall a bit of this Committee's history. The Association appeared before this Committee's Subcommittee on Financial Institutions in 1975, when then-Chairman McIntyre held hearings on S. 890. That bill had been submitted to Congress by the Federal Reserve Board in the aftermath of the failure of Franklin National Bank, and would have allowed the interstate acquisition of failing banks and bank holding companies. The Association of Bank Holding Companies strongly supported S. 890, but predictably the Fed's proposal generated alarm in the same quarters where it occurs today. Because the opposition was so vehement, the Committee dropped the interstate acquisition provisions and instead approved streamlined procedural revisions that later became law.

In revisiting the question in 1981 and 1982, Congress responded to new requests from the regulators to allow special handling to troubled banks and thrifts. Again, protests were heard to the effect that the regulators' proposal would open the doors wide to full nationwide banking. Congress reacted to the protests by erecting a series of hurdles for out-of-state bidders before they could purchase either a bank or a thrift. S. 2372 retains these hurdles intact, and they have had their effect. After four years, only one transaction involving the purchase of a failed bank by an out-of-state bank holding company has occurred (Chase Manhattan Corporation's purchase of Park Bank, St. Petersburg, Florida) and the regulators again feel that public policy requires them to have improved standby authority for use should an emergency require.

Clearly, as these examples indicate, the floodgates to nationwide banking were not opened by the 1982 "Garn-St Germain Act," nor will they be opened by S. 2372. I wish to emphasize the point that, from the view of the management of bank holding companies, the acquisition of a failing, or failed, institution is a deliberate undertaking, prone to unpleasant surprises and higher costs than anticipated. Purchasing a failing institution, therefore, is not necessarily a golden opportunity. To make such an acquisition succeed, much time, energy, and patience are required. Yet, from the standpoint of depositors, and the protection of the federal deposit insurance funds, such acquisitions are clearly sound public policy.

In spite of these considerations, the same arguments are being leveled against S. 2372 that were raised against the proposals in 1975 and 1982. The continuing opposition has led the regulators to add restrictions to the bill that we believe go too far. Once again we are in danger of frustrating the purpose of those in the best position to supervise the safety and soundness of the banking system. In the view of the Association, Congress should void, or at least minimize, the disincentives in order to attract capital in emergencies to troubled institutions. Further restrictions run the risk of again creating overkill--so circumscribing this emergency authority that its purpose is frustrated. The proposed bill already verges on that point.

Specific Provisions

For example, the bill lowers the threshold measure for eligibility of banks from $500 million to $250 million, and permits a bank holding company to be acquired by an out-of-state purchaser--but only if the in-state company has

a bank subsidiary (or subsidiaries) with assets of $250 million or more that is in danger of being closed; furthermore, these troubled assets must constitute 33% or more of the holding company's banking assets. Finally, the out-of-state acquirer is limited, after everything else, to making additional acquisitions only in the three largest metropolitan areas in the home state of the acquired institution. Thus, the rescuer is expected to operate at a competitive disadvantage, once the rescue is accomplished. This is hardly an inducement.

Out-of-state bank holding companies acquiring a failing institution should be accorded the same geographic expansion rights as are available to in-state institutions. Geographic diversification is generally regarded as a strength. To deny geographic diversification opportunities to a rescued, but perhaps still troubled, bank holding company would be counter-productive, and would make it more difficult to restore the patient to health. We believe, therefore, that the metropolitan-area limit should be eliminated.

With regard to the percentage restriction on the impaired assets of a bank holding company, it is certainly not unreasonable to assume that a company with 33% of its banking assets impaired should constitute a basis for action by the regulators, including the invocation of the interstate bidding procedures. However, is it not an unreasonable presumption that this would be the only situation warranting such action? In other words, how can anyone be certain that 33% is the correct number? It would be preferable for Congress to allow the regulators the flexibility to exercise their judgment in problem situations that have not reached the 33% threshold.

It is not possible to quantify the effects such limitations may have on restricting the number of prospective bidders. Of course, each situation is different. We do know that the constraints in the "Garn-St Germain Act" have resulted in relatively few occasions when a formal bidding process has occurred involving a failing bank, and, as indicated, such a process was actually completed in just one instance. Only time will tell what effects the new restrictions would have, but they certainly constitute disincentives in a bill whose clear purpose is to attract the interest of healthy institutions to purchase and rehabilitate failing ones.

Basic Principles

In the Association's 1975 statement to this Committee, we stated several principles that are still relevant. First, all possibilities of a rescue within a state should be exhausted before bidders are sought out-of-state; second appropriate coordination among federal and state banking agencies should take place; third, the agencies should be authorized to act before an institution has reached the point of imminent failure, so that there is still some degree of equity left in the bank and a greater probability that it can be made a successful operation; and, finally, a national policy should be established by the legislation and it should not be hampered by restrictive state laws.

We could have added another principle: that a market solution to failing situations is the American way, and to limit bidders is to prejudice the rights and opportunities of shareholders.

Other Provisions

S. 2372 would allow the bank regulatory agencies the flexibility to deal with "failing" banks and bank holding companies, as well as "failed" banks, and we strongly support this modification. The new authority would ease the potential burden on the federal deposit insurance fund and consequently on the nation's commercial banks that maintain the fund through their yearly assessments. When employed, it will make acquired institutions healthier, more quickly, because they will have broader support than that obtained by regulator intervention.

Two subparagraphs--Sec. 5(D) and Sec. 5(E)--provide new and unique authority to state bank supervisors in the case of "unassisted transactions." In these cases, the state supervisor would make the determination as to which company was the winning bidder, without regard to the amount of the bids or shareholder interests. The Federal Reserve Board is given a secondary role, able to intervene only if it finds inadequate managerial or financial resources in the acquiring institution chosen by the supervisor. Congress should carefully consider whether it wishes to give state banking supervisors this much latitude, displacing, in these transactions, the role of the Federal Reserve Board as the principal supervisor of bank holding companies.

Also, if Congress were to enact S. 2372, and thereby set a national policy for dealing with troubled depository institutions, we believe it should be permanent law. There is a continuing need on the part of the regulators to have this precautionary authority. Congress can reopen the matter at any time by holding hearings and passing new legislation, but in the meantime the basic law should be maintained. We are therefore opposed to the "sunset" provision in S. 2372. Customers of depository institutions should know that there is a permanent program in place to handle emergency situations; the need to assure safety and soundness is ongoing.

Extraneous Amendments

I should like to deal briefly with extraneous amendments that have been proposed for addition to S. 2372. In every case, we are opposed to them. S. 2372 should be considered on its own, as a specific extension and incremental expansion of the emergency acquisition authority in the "Garn-St Germain Act;" other amendments should be rejected.

Concentration of Resources. A number of mergers and acquisitions is occurring among regional bank holding companies stimulated by the Supreme Court's decision last year upholding regional banking statutes. Moderate-size regional companies are combining, and many of the resulting institutions are of significant size, even in comparison to money-center banks such as Marine Midland. Does this mean that banking is becoming more concentrated, or that the public is being denied adequate economic choices? State supervisors have not thought so in several recent examples, and we agree.

The mere fact of an intrastate or interstate consolidation does not mean that local or regional markets are threatened; in fact, just the opposite is usually the case. The data continue to show that banking remains one of the least concentrated industries. The merged institutions can—and do--invigorate local and regional markets.

Two examples are relevant. First, the Superintendent of Banks for the State of Maine reported on January 15, 1985, that ". . .banks which are part of a financial institution holding company have experienced a more rapid growth of loans. Those holding companies with out-of-state ownership have exceeded all other financial institutions in the lending area." The preceding year, he reported, loan growth at banks owned by out-of-state companies was double that for banks owned by in-state companies. Second, an article in the February 15, 1985, edition of the Economic Commentary, published by the Federal Reserve Bank of Cleveland, reported on a study of Ohio markets showing that when more banks and other depository institutions were active in a market, consumers benefited by receiving higher interest rates on their savings accounts.

We think it is significant that when the Senate overwhelmingly passed S. 2851 on September 13, 1984, the interstate banking provision (Title IX) that endorsed regional banking statutes did not contain any restrictive antitrust provisions. Obviously, the Committee and the full Senate concluded at that time that no such provisions were necessary, and we certainly agreed. Today, we see no reason to change that view, and the Association will continue to oppose vigorously the imposition of concentration restrictions, either in the context of S. 2372 or in any other context.

Community Benefits. Some have urged that community reinvestment standards, which now are applicable to all acquisitions, be greatly strengthened solely in conjunction with this legislation. There are two responses I should like to make to such a proposal.

First, S. 2372 is a consumer protection bill in its most fundamental sense. Its whole purpose, together with the efforts of the regulators and the operation of the insurance funds, is to protect depositors and assure that the customer services provided by failing institutions will continue to be available with a minimum of disruption. There can be nothing more important to consumers, small businessmen and farmers than the preservation of a failing institution as a viable banking option. This is perhaps the finest community service that an out-of-state acquirer can provide.

Second, the addition of heightened requirements for community reinvestment in the context of emergency banking legislation would be contradictory. As I have indicated earlier, Congress should be focusing on ways to engage the interest of out-of-state bidders in acquiring failing institutions. If such transactions are going to trigger more severe community reinvestment standards than apply under current law, then it is doubtful that many bankers will be interested in exploring such acquisitions.

"Non-Bank Banks." Section 7 of S. 2231, which this Committee approved on March 25, contains a moratorium on "non-bank bank" expansion, and S. 2851, passed by the Senate in September 1984, contained a revised definition of "bank." Suggestions have been made that S. 2372 be made the vehicle for similar amendments. We strongly oppose such proposals.

The issue of "non-bank banks" is a complex one. We supported S. 2851, which included a redefinition of "bank" that exempted S&L's, but would have

STATEMENT OF MR. JOHN E. MALARKEY
ON BEHALF OF
THE CONFERENCE OF STATE BANK SUPERVISORS

BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

S. 2372, THE "FINANCIAL INSTITUTIONS EMERGENCY
ACQUISITIONS AMENDMENTS"

MAY 14, 1986

Mr. Chairman, members of the Committee, I am John E. Malarkey, State Bank Commissioner for the State of Delaware and President of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the primary source of educational and research services aimed at strengthening individual state banking departments.

We are pleased to have this opportunity to testify before this Committee and discuss current legislative proposals for the expansion of the emergency authority of the Federal bank regulatory agencies. Let me state, at the outset, that CSBS recognizes that a problem exists, particularly in certain areas of the country and with certain types of banks, especially those heavily committed to agricultural and energy lending. CSBS is willing to work with the Federal agencies to expand their regulatory flexibility and better utilize their existing authority. However, the scope of current problems has been insufficiently defined to sustain the broad request for increases in statutory authority now proposed by the Federal agencies. CSBS would be willing to support legislation which is necessary to meet the

8. The emergency authority granted should sunset in not more than five years.

In addition, CSBS feels strongly that the FDIC should not be allowed to sell an entire BHC as a package deal; however, an out-of-state purchaser of a lead bank of a BHC should be treated as an in-state bidder for subsequent transactions, unless specifically precluded by state law. If BHC "packaging" becomes the rule it will create a strong bias toward interstate sale by forcing bids on larger, more expensive packages, and reducing the number of potential in-state bidders. Also, the multiplicity of locations of a BHC could mean that a "package" acquisition may not make good business sense and may even create antitrust problems for potential in-state buyers already operating in that market. Selling off profitable subsidiaries of the BHC separately, as is current practice, continues to make good business and policy sense. The possibility of "parcelling" the assets of a BHC for offer intrastate, so that something less than the entire BHC could be bid on would also help in this regard.

Finally, CSBS strongly believes that legislation is needed to close the nonbank bank loophole because the existence of the loophole undercuts the motivation to acquire problem institutions of any type.

Thank you Mr. Chairman, members of the Committee. I would be happy to answer any questions you might have.

The **CHAIRMAN**. Thank you, Mr. Malarkey.

Mr. Doyle, in your testimony you certainly indicated your concern for nonbank bank loophole closure and about unregulated nonbank banks. I have a copy of a legal analysis by the American Financial Services Association saying that nonbank banks are regulated just the same, and it has far too many points for me to ask you to respond to it now, but I would appreciate it if by Monday or Tuesday of next week you could respond to it with a written analysis of your response to the points made about the regulation of nonbank banks.

Mr. **DOYLE**. Yes, sir. We would be happy to.

[The following material from IBAA and reply from AFSA were subsequently submitted for the record:]

situation, provided that such legislation provides adequate safeguards to ensure that it is used as a last rather than a first choice. CSBS will never support measures to insulate the Federal deposit insurance fund from assisting transactions or paying the depositors it insures, if necessary, by selling interstate franchises in contravention of state law, the Douglas Amendment and the orderly evolution of the banking structure. In essence, our position is that the Douglas Amendment is not and should not be for sale.

Background

As you, the members of this Committee, well know, Section 116 of the Garn-St Germain Act authorizes the FDIC, as receiver, to arrange the sale of assets and assumption of liabilities of a closed bank with total assets of $500 million or more to an out-of-state bank or bank holding company. With respect to insured banks organized in mutual form, with $500 million or more in total assets, Section 116 further provides for the interstate sale of assets and assumption of liabilities or the interstate merger of such an institution which is "in danger of closing." However, the FDIC may use this authority "only where the board of trustees of the insured bank and the appropriate Federal or State chartering authority have specified in writing that the bank is in danger of closing and have requested in writing that the Corporation assist a merger or a purchase".

The Federal bank regulatory agencies have now proposed greatly liberalizing their own authority to deal with problem banks by permitting the interstate sale of banks and bank holding companies "in danger of closing" and reducing the asset size eligibility test from $500 million to $250 million. This proposal represents a serious divergence from our current system of bank regulation and includes many elements rejected by Congress in passing the emergency provisions of the Garn-St Germain Act. Those who propose changes bear the burden of showing that such changes are necessary and that there are not significant disadvantages involved in making the proposed changes. CSBS believes that the Federal agencies have failed to meet that burden on both counts.

The FDIC has built its case for expanded authority for the interstate sale of "failing" banks around the need to protect the insurance fund. It contends that a decreased loss to the insurance fund would result from flexibility in locating interstate buyers at an earlier stage, and from the ability to act at an earlier point in time, thereby stemming losses and outflow of uninsured accounts. In essence, it is expected that a higher premium would be paid for a bank that has not been closed and/or an entire BHC, including its healthy assets and several locations.

We agree with the FDIC that the uninterrupted provision of services and the maintenance of public confidence are extremely desirable ends. We have worked with the Federal agencies toward these ends both here in Washington and in individual states.

However, the legislative approach which has been proposed by the federal regulators boils down to financing the deposit insurance fund, already paid for by the industry, with a yearend balance of $17.9 billion, by selling interstate franchises to rich buyers in states where such would not otherwise be available.

Need For Proposed Legislation

The burden of proof that the proposed changes are necessary has not been met nor has the scope of the problem been defined.

First, the FDIC has not demonstrated a need for the expansion of its authority to include the interstate sale of banks in danger of closing on the basis of inadequacy of current law. State laws and regulations have provided adequate flexibility to arrange such transactions and, in several cases, have been specifically amended to accomodate the interests of the FDIC in handling failing banks. In one case, a remedial state statute was enacted within one week. It must be remembered that the interest of the state in fashioning a timely and suitable remedy to a problem situation is at least as great as that of the FDIC, if not more so.

Cooperation and flexibility are the two key elements in handling a bank failure. With the primary regulator working closely with the insuror of the critically wounded institution, the combined expertise, resources and regulatory tools of the

State and Federal systems can be brought into play. Experience has shown that an efficient and minimumally disruptive solution can be accomplished at a relatively low cost loss to the FDIC fund.

Second, the FDIC has not demonstrated that any significant *cost* savings would accrue from the proposed expansion of its authority. Certainly, it is not true that *cost* savings would be universal, as has been implied. In some cases, the regulatory tool selected to meet broader objectives may not represent the lowest projected *cost*. Historically, however, there has not been a wide spread between the actual *loss* figures for the various tools. In point of fact, mergers are often arranged prior to actual closing of the institution over a weekend, with the acquired institution reopening for business on the next business day. This is done under the authority of the Office of the Comptroller of the Currency and the State Banking Departments, working in cooperation with the FDIC. Little or no savings would accrue to the fund in these instances under the proposed changes. Further, it could be counterproductive to signal the demise of a bank by formally classifying it as failing and openly seeking bidders, which would tend to cause earlier outflows of uninsured accounts and would destroy some of the flexibility that now exists in the handling of troubled banks. Also unaffected would be those instances in which pay-off is the required supervisory tool because of the presence of fraud or other illegal activities.

Third, the FDIC has not made any specific case with regard to the sale of entire BHCs as a package. It has not shown that it could not successfully sell the lead bank alone, that the remaining holding company could not survive after sale of the lead bank, or that selling off the healthy parts of the BHC to revive the troubled lead bank, the traditional way of handling such problems, is not still the most effective way of handling such problems. All they have alleged is that they can get more out of the interstate sale of a big package, including healthy banks, than they can for a single problem bank. The interstate sale of healthy banks for the benefit of the insurance fund has *never* been contemplated by Congress as a part of any emergency authority, not should it be.

As you know, CSBS monitors developments in state banking law throughout the nation. We have seen several states, faced with difficulties, adopt emergency interstate provisions under their general authority and their authority under the Douglas Amendment. Yet, state legislatures in several states affected by recent developments have declined to do so. The Federal agencies would have you believe that these state legislators are irresponsible and that is why you must act. This is simply not true. The impact of bank failures is felt most keenly at the state and local level. Rather, a bird's-eye view of the problem at the state level may suggest that the problem is not so severe as to warrant the sweeping changes proposed by the Federal agencies. In fact, recent develpments suggest that the economic downturns of concern are "bottoming out" and that the true scope of the problems with which we must deal may now be more responsibly assessed.

Disadvantages Of Proposed Legislation

The burden of proof that there are not significant disadvantages involved in making the proposed changes has also not been met. In fact, there are serious, legitimate countervailing considerations:

1. Broader public interests should be served in deciding whether and when to close a bank, not merely the protection of the insurance fund. Whether or not it is true that earlier closing of a problem institution will result in a smaller loss to the fund, broader public interests are served by our system of bank regulation and are entrusted to the primary regulators of banks. These other objectives, including the rehabilitation of institutions, may well be forgotten by an agency with limited scope.

The bottom line in the handling of any bank failure situation is the maintenance of banking services and public confidence in a stable banking system. Surviving institutions should have an opportunity to operate in an environment that has been disrupted to the least extent possible and the public should be able to continue receiving loans and deposit services with minimum inconvenience and added cost. The FDIC fund was created to protect depositors and to promote the stability of the banking system. Banks have contributed to the fund for these purposes. Protection of the fund, in and of itself, is not the primary goal of the failing bank exercise.

2. Expansion of FDIC authority to sell interstate franchises represents an unwarranted departure from our current system of bank regulation. It is the primary regulator, which grants the charter and is responsible to the public for performance under that charter. Decisions as to appropriate bank structure, balancing the need for competition with the natural tendency to concentration of financial markets, are made at the state level. Individual states have been determined to be in the best position to pass judgement on the questions involved in bank structure. Mr. Chairman, as you have said, "The emergency powers are tantamount to a major rewriting of the Nation's banking laws, particularly the McFadden and Douglas Acts relating to interstate banking."

Obviously, there are implications for the insuror of the institution in both the timing and the way in which a failing bank situation is handled. However, the sale of interstate franchises, a waiver of existing law with competitive advantages, for the benefit of a few already advantaged institutions, should not be undertaken unless absolutely necessary. It is deplorable to think that the largest institutions in the nation and the shareholders of problem banks will benefit from economic problems under which others must suffer. Windfall profits coming from the

interstate sale of problem banks, like "war profits", should not reward shareholders of those institutions.

3. There is great potential for the abuse of discretion in the determination of what is a "failing" institution or when such authority should be invoked. Agency action has not always been even-handed in its use of discretionary powers, which may result in selectivity inconsistent with the purposes of the Federal Deposit Insurance Act. There is potential for discrimination by size or type of bank, or it may be occasioned by the desire to undercut a particular state which has not been sufficiently "progressive." It would certainly depend in part on the "marketability" of an institution, with portfolio and geographic advantage being prime factors. Individual states or whole regions could possibly bear the brunt of discriminatory use of the interstate sale of problem institutions. In addition, a "race to the courthouse" atmosphere could be generated, with the FDIC competing to be first in line with its hand-picked interstate partners. The decision of when to close an institution should be one guided by broad public policies, not the desire to control the mechanism of the disposition of that institution.

4. The safeguards provided by proposals to date are wholly insufficient in protecting valid state and local interest in the banking system. It has been argued that, by requiring that both the Board of Trustees of the troubled bank and its

chartering agency specify that the bank is in danger of closing and request FDIC assistance, any valid state interest has been accounted for.

First, the argument wholly ignores the politics of the problem bank situation. It ignores the leverage which the FDIC has over the officers and Board of a problem bank. This leverage can be used both to get the necessary written request and to solicit an application for a change of charter to a national charter, if such a change suits the FDIC's purposes. Moreover, the threat of the use of a pay-off, rather than a post-closing merger or purchase and assumption, coupled with the potential for a charter change can be used to bring direct pressure on an individual supervisor.

Second, if the troubled bank is a national bank, the mechanism is in the hands of the OCC. There is no accounting for valid state interest in maintaining control over both its bank structure and its capital delivery system. The only applicable "safeguard" in the case of a national bank is the consultation requirement, under which the objections of the state supervisor can be overcome by a unanimous vote of the FDIC, the body which proposed the interstate sale in the first place.

5. The expansion of the FDIC's ability to sell banks "in danger of closing" would undercut the current market for failing thrifts. This should be of serious concern to anyone acquainted with the current condition of the thrift industry and the FSLIC.

In a related matter, it would undercut the safeguards which we were successful in having imposed on cross-industry and interstate thrift acquisitions, namely the requirement that these thrifts abide by bank branching standards and the requirement that they continue to be operated as thrifts. The market for "qualified thrift lenders" will be greatly reduced if "full service banks" may become available in the same market.

It is important to understand that the proposed changes expand authority to deal with banks and BHCs, not with thrifts. Section 123 of the Garn-St Germain Act already provides for the interstate and cross-industry acquisition of any size S&L which is eligible for assistance, upon a determination by FSLIC that "severe financial conditions exist which threaten the stability of a significant number of insured institutions, or of insured institutions possessing significant financial resources," and that such an action would lessen the risk to the Corporation. Proposed changes would undercut, rather than enhance, the market for failing thrifts created by this section.

CSBS believes that possible alternatives to the drastic legislative proposal before you have not been adequately explored. We believe that opportunities to assist intrastate transactions through the use of "bridge" banks or other mechanisms which buy time for the FDIC should be taken advantage of. Forgotten in the debate to date is the rule that the least drastic alternatives should be explored first. Perhaps proponents of sweeping changes have forgotten that assisted intrastate transactions have always been a reasonable alternative and that least cost to the insurance fund is not always the least societal cost. We would hope that insulation of the insurance fund, which is definitely not on the verge of bankruptcy, against any loss has not become a convenient means for other legislative ends.

Necessary Legislative Safeguards

If a need for legislation to supplement the FDIC's existing authority can be shown, we are willing to work with Congress and the agencies to minimize the serious disadvantages in the proposed changes identified above. Such legislation, in order to have the acceptance of CSBS, would have to include the following elements:

1. The definition of a "failing bank" eligible for emergency interstate acquisition should be strictly drawn.

2. Any emergency acquisition under the expanded authority should be permitted only if the state banking regulator in the failing institution's home state does not object to the acquisition.

3. Stockholders in the "failing" bank should be required to agree to limit windfall profit-taking to 1/3 of net book at time of sale or 1/3 of market value as measured by net proceeds of sale of the institution, whichever is less, in instances of interstate sale; alternatively, authority for the interstate sale

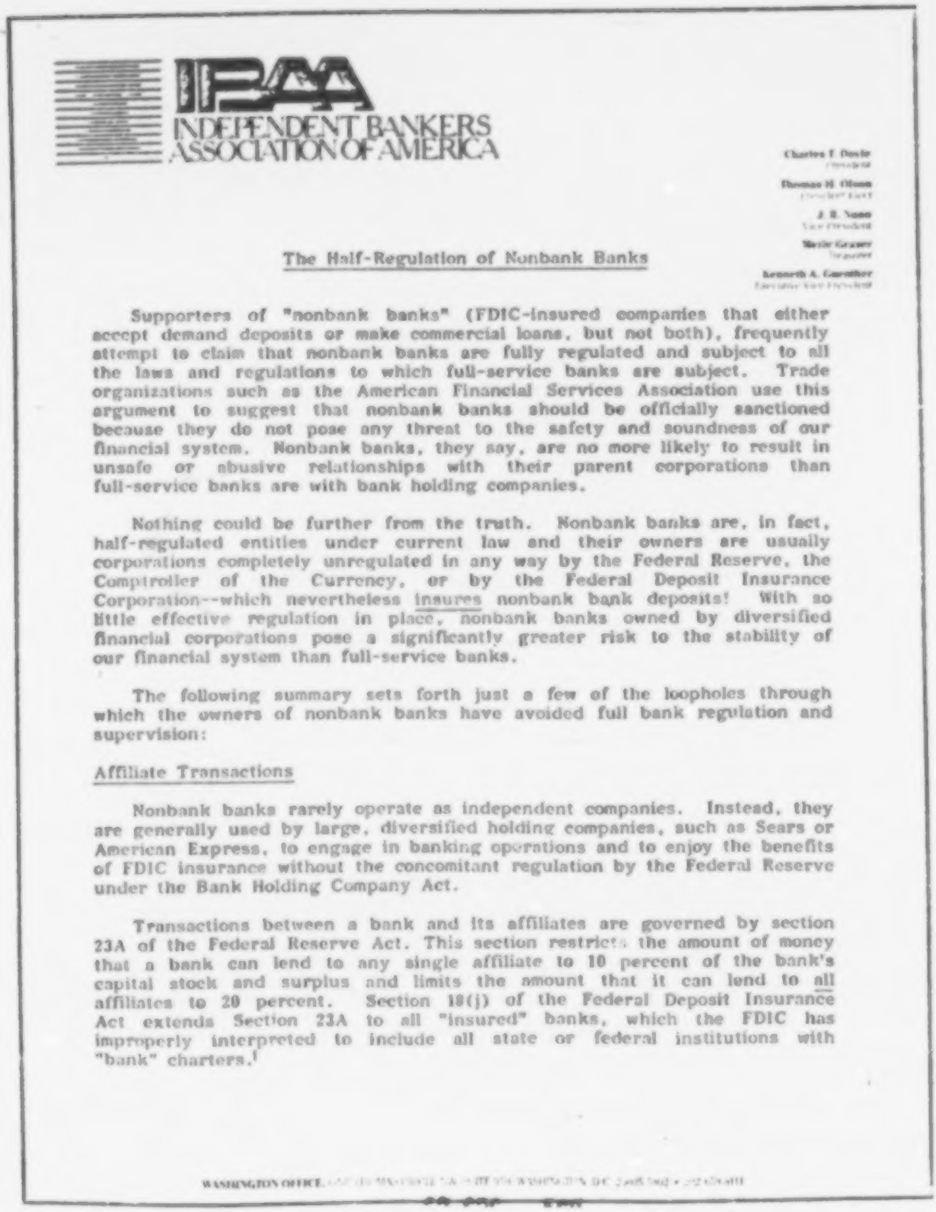
of banks "in danger of closing" should be limited to assisted transactions only, cases in which no premium above making the FDIC whole will accrue.

4. The threshold size of institutions eligible to be acquired should be not less than $500 million or one of the four largest banks in a state, which would account for states where even the largest banks do not meet the current threshold without drastically increasing the pool of banks eligible for interstate sale in other states.

5. Both the primary regulator of the bank and the Board of Directors of the bank should be required to specify both that the institution is in danger of closing and that FDIC assistance under this section appears to be an appropriate solution in a particular case.

6. A meaningful preference for intrastate acquisition, under which the FDIC need not be made 100% whole, but may assist an intrastate transaction before peddling an institution interstate should be written into the bill.

7. Reoffer provisions should be made meaningful by giving bidders estimates on cost to the FDIC fund and other pertinent information.



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The Half-Regulation of Nonbank Banks

Supporters of "nonbank banks" (FDIC-insured companies that either accept demand deposits or make commercial loans, but not both), frequently attempt to claim that nonbank banks are fully regulated and subject to all the laws and regulations to which full-service banks are subject. Trade organizations such as the American Financial Services Association use this argument to suggest that nonbank banks should be officially sanctioned because they do not pose any threat to the safety and soundness of our financial system. Nonbank banks, they say, are no more likely to result in unsafe or abusive relationships with their parent corporations than full-service banks are with bank holding companies.

Nothing could be further from the truth. Nonbank banks are, in fact, half-regulated entities under current law and their owners are usually corporations completely unregulated in any way by the Federal Reserve, the Comptroller of the Currency, or by the Federal Deposit Insurance Corporation--which nevertheless insures nonbank bank deposits! With so little effective regulation in place, nonbank banks owned by diversified financial corporations pose a significantly greater risk to the stability of our financial system than full-service banks.

The following summary sets forth just a few of the loopholes through which the owners of nonbank banks have avoided full bank regulation and supervision:

Affiliate Transactions

Nonbank banks rarely operate as independent companies. Instead, they are generally used by large, diversified holding companies, such as Sears or American Express, to engage in banking operations and to enjoy the benefits of FDIC insurance without the concomitant regulation by the Federal Reserve under the Bank Holding Company Act.

Transactions between a bank and its affiliates are governed by section 23A of the Federal Reserve Act. This section restricts the amount of money that a bank can lend to any single affiliate to 10 percent of the bank's capital stock and surplus and limits the amount that it can lend to all affiliates to 20 percent. Section 18(j) of the Federal Deposit Insurance Act extends Section 23A to all "insured" banks, which the FDIC has improperly interpreted to include all state or federal institutions with "bank" charters.[1]

Section 23A was enacted to protect the safety and soundness of our banking system by 1) limiting the ability of nonbanking affiliates to siphon off bank deposits in order to fund highly speculative or unsound ventures and 2) insulating a bank from the failure of such affiliates. Each bank regulatory agency has the responsibility to regulate and monitor affiliate transactions under Section 23A, including those between a nonbank bank and its parent. However, they do not have authority to examine Sears as a nonbank holding company. This is one of the main reasons why the Bank Holding Company Act was enacted in 1956--to give the Federal Reserve explicit authority to supervise the other side of these affiliate transactions, namely, the holding company.

The following is a list of some of the improper affiliate transactions which the Federal Reserve currently looks for in its on-site examinations of bank holding companies:

(1) Excessive dividends received by a holding company from one or more of its bank subsidiaries,

(2) Unsafe or unsound loans extended to a holding company by one or more of its banks,

(3) Excessive management or service fees paid to a holding company by one or more banks,

(4) The improper allocation of taxes among a holding company and its various subsidiaries,

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[1] On its own initiative, the FDIC has chosen to interpret section 18(j) to authorize the extension of FDIC insurance to any entity which has a national or state bank charter. This means, in effect, that if a state chartering authority or the OCC chose to grant a bank charter to a McDonald's restaurant that accepted demand deposits, then the FDIC would consider it qualified for federal deposit insurance. It seems odd that the FDIC would willingly increase its insurance liability to cover such businesses. In 1982, when Congress allowed industrial banks and similar institutions to obtain FDIC insurance, it added the qualification that the FDIC, prior to granting insurance, "shall determine that [the institution] is chartered and operating under laws providing for examination, supervision, and liquidation substantially comparable to those applicable to banks operating in the same state." 12 USC 1815(a) (emphasis added). Since transactions between a nonbank bank and its owners are not subject to full bank supervision, the FDIC could legally deny coverage to any such nonbank bank.

Under the previous Comptroller, the OCC was equally cavalier with the extension of national bank charters to nonbank banks. Last year, the IBAA obtained a federal district court injunction blocking any further action on pending applications. In that case, the court ruled that the Comptroller exceeded his authority under the National Banking Act by granting charters to those institutions which are not engaged in "the business of banking," i.e. do not both make commercial loans and take demand deposits. IBAA v. Conover, ___F.Supp.___ (M.D.Fla.1985).

(5) The improper sale or transfer of assets between a holding company and its subsidiaries,

(6) Excessive compensating balances which a holding company may require a bank to keep at correspondent banks.

Such transactions may indicate either an attempt to use the bank as a means of using insured deposits to fund high-risk (or even fraudulent) nonbanking activities or an unsafe and unsound intermingling of banking and nonbanking activities. Federal Reserve examiners, of course, are unable to make similar checks on the owners of nonbank banks.

Examinations

Nonbank banks with national bank charters are subject to examination by the OCC, while state-chartered nonbank banks are subject to state and FDIC examinations. However, since most nonbank banks are subsidiaries of unregulated corporations, they are only subject to half the supervisory attention which a full-service bank receives when it is part of a bank holding company.

How is the FDIC supposed to accurately gauge the health of a nonbank bank if it can neither examine the nonbank bank's owner nor rely on the examination reports of the Federal Reserve? When the FDIC examines a state-chartered full-service bank that is part of a bank holding company, it relies upon the Federal Reserve's independent analysis and on-site inspection of the holding company and compares the Fed's findings with its own. Conversely, the Federal Reserve uses the FDIC's review of the individual banks in a holding company to assess the holding company's consolidated financial condition. In fact, the Federal Reserve refers to its examination process as a "building block" approach, whereby it examines each bank subsidiary, then each nonbank subsidiary, and finally the consolidated financial statement of the entire holding company. (See Attachment A) In this way, the Federal Reserve draws upon a number of independent sources to monitor the health of the holding company and its relationship with individual bank subsidiaries.

If problems arise during the course of a holding company examination, all three bank regulators can join together to perform simultaneous examinations, thus allowing the regulators to get a complete snapshot of the company's operations at a single moment in time. This is particularly helpful when fraud is suspected. The bank regulators simply cannot do this where Sears or E.F. Hutton is the holding company.

Nonbank Activities of Affiliates

This country has traditionally required that the business of banking be kept separate from commerce. This has been done to protect banks against general economic failures and to protect the independence of the credit-extending process. Congress has placed limits on the types of nonbanking activities in which banks can engage, either directly or indirectly, through the device of the bank holding company. Under section 4(c)(8) of the Bank Holding Company Act, bank holding companies can only engage in very limited nonbanking activities or ones that are "so closely related" to banking as "to be a proper incident thereto." The Federal Reserve has the obligation to monitor the nonbanking activities of bank holding companies to ensure that they do not stray too far afield from the business of banking and to require that expanded nonbank activities meet a "public interest" test. To meet this test, the Federal Reserve must find that the proposed activity "can reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices)." No such "public interest" test is applied to acquisitions by nonbank banks or their owners.

Nonbank banks, of course, are owned by corporations largely to avoid 4(c)(8) restrictions. Recently, there have been indications that unhealthy tie-ins are beginning to appear between nonbank banks and their owners. For example, Sears has been accused by a California real estate developer of attempting to force him to install Sears appliances in a condominium project financed by Sears' subsidiary, Sears Savings Bank. (See Attachment B) Such anticompetitive practices by Sears or other nonbank holding companies, however, are not currently within the jurisdiction of any bank regulatory agency.

Even money center bank holding companies are able to avoid the strictures of section 4(c)(8) by securing charters for nonbank banks in states permitting the widest possible range of activities by banks and then using their state charters to acquire businesses that are totally unrelated to banking under section 4(c)(8) of the Bank Holding Company Act. There is no question that the operations of these other businesses could have a detrimental effect on the health of the insured nonbank bank. For example, in the District of Columbia, Chase Manhattan Bank and others are currently seeking to enter the insurance business without the approval of federal regulators and to use nonbank banks to acquire other banks in the region. (See Attachment C) While insurance operations *per se* may not pose any threat to the health of an insured nonbank bank, it is undeniable that the insurance operations of a nonbank bank and its affiliates are not scrutinized by federal bank regulators.

Interstate Acquisitions and Branching

Nonbank banks can also be used by their owners to circumvent the Douglas Amendment to the Bank Holding Company Act, which prohibits interstate bank acquisitions without the specific assent of the target bank's state. By using a nonbank bank, a holding company can evade the Douglas Amendment and use the nonbank bank to engage in interstate deposit-taking. Similarly, the restrictions of the McFadden Act on the interstate branching of national banks are also circumvented if a holding company can use a nonbank bank to take deposits in other states. Thus, the dual supervision of banks by state and federal regulators is greatly undermined by the device of nonbank banks.

Community Reinvestment

The Community Reinvestment Act requires full-service banks to meet the credit needs of low- and moderate-income communities. If a nonbank bank only makes consumer loans and is legally prohibited from making commercial loans to minority-owned and small businesses, it is difficult for such an institution to satisfy Congress' intent that banks should meet the full range of credit needs of a community. It is questionable whether nonbank banks would ever be able to meet the community business reinvestment standard currently being met by full-service banks.

Management Interlocks

Management officials of full-service banks are prohibited from simultaneously serving as managers of competing depository institutions. Congress enacted the Depository Institutions Interlock Act because management interlocks have the potential to produce conflicts of interest that can reduce competition and endanger the safety and soundness of insured banks and other financial institutions.

The owners of nonbank banks, on the other hand, are free to serve as management of their banking competitors, since nonbank holding companies do not fall within the scope of the Act.[2] It is unclear whether the regulators of nonbank banks even have the authority to investigate or restrict such interlocking directorates.

Bank Merger Act

Mergers or acquisitions involving nonbank banks and their corporate parents are not generally subject to the same degree of antitrust scrutiny that mergers involving full-service banks and bank holding companies receive. When a full-service bank seeks to acquire another bank, the acquirer must seek advance approval from the OCC if the resulting bank would be a national bank, from the FDIC if it would be a state nonmember bank, or from the Federal Reserve if it would be a state member bank.

The banking agency then conducts a competitive analysis to determine whether the proposed transaction would tend either to reduce competition or create a monopoly. In addition, the other two banking agencies and the Justice Department must submit their own independent reports. The responsible agency then weighs the competitive factors with other "banking factors" (the financial or managerial resources of the two institutions and the convenience and needs of the community to be served) before ruling on the proposed merger.

Nonbank bank acquisitions, on the other hand, are treated much differently. They may be subject to a full review, a truncated review, or no review at all, depending upon the circumstances of the particular case. For example, if a bank or nonbank bank seeks to acquire a nonbank bank, the full Bank Merger Act antitrust standards and procedures apply. However, if a nonbank holding company seeks to acquire a nonbank bank, then the Change in Bank Control Act, not the Bank Merger Act, applies. This means that while the nonbank bank's primary bank regulator is required to conduct a competitive analysis, the other banking agencies do not submit competitive reports on the other parts of the holding company nor on other competitors in the bank's market. In addition, the Department of Justice is entirely left out of the approval process.

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[2] 12 USC 2301 provides that only officials of "depository institutions" are covered by the Act. These are defined as a bank holding company under section 2(a) of the Bank Holding Company Act of 1956 and a savings and loan holding company under section 408(a)(1)(d) of the National Housing Act.

Lastly, if the corporate parent of an existing nonbank bank seeks to expand its financial services by forming or acquiring a company that competes for banking services (e.g. a mortgage or consumer finance company) but is not federally regulated, then no federal banking agency has any input at all. The only agency that could potentially challenge such an acquisition would be the Justice Department. However, this is extremely unlikely, since prior approval is not required by Justice and no objections are likely to be raised by an agency that has no regular involvement with the affairs of financial institutions.

Glass-Steagall Act

It is ludicrous to suggest, as some have done, that nonbank banks are subject to the same restrictions on their securities activities that member banks must meet. Under Glass-Steagall, no bank that is a member of the Federal Reserve may engage in the purchase or sale of securities for its own account or in the underwriting of such securities, nor may a bank be affiliated with any firm engaged principally in securities activities. In addition, the Act prohibits interlocking directorates and other managerial relationships between member banks and securities firms.

These restrictions have been circumvented by securities firms that have either acquired nonbank banks which are not members of the Federal Reserve or convinced the regulatory agencies that Glass-Steagall does not apply to them because they constitute diversified financial corporations not "principally engaged" in securities transactions (e.g. Dreyfus Corporation). As a consequence, the potential exists for significant conflicts of interest between these nonbank banks and their securities industry owners, but the bank regulators have not established a supervisory or regulatory apparatus to monitor intercompany transactions.

Payments System

All full-service banks and bank holding companies that have access to the Federal Reserve payments system are subject to check collection and wire transfer procedures and to close regulatory supervision. This protects the payments system against massive overdrafts and ensures that the failure of a single financial institution does not present a sudden drain on the nation's central bank.

Nonbank banks and their parents are not fully subject to the Federal Reserve's supervision of the payments system. Large bank users of the payments system are subject to close, sometimes even daily, monitoring by the Federal Reserve in order to protect the central bank if one of the nation's largest financial institutions should suddenly deteriorate or commit fraud and use the payments system to obtain access to unlimited cash. With the increasing volume and speed of the payments system, this potential threat to the monetary system has caused considerable concern at the Federal Reserve. The agency, however, has no comparable advance warning system for large diversified corporations that use nonbank banks to gain access to the payments system.

Enforcement Authority

It is unclear what authority the bank regulators have to take enforcement action against individuals who manage or own parents of nonbank banks. Under Section 8 of the Federal Deposit Insurance Act, the banking agencies' authority is limited to officers, directors, employees, agents and "other persons participating in the affairs" of a bank. It is doubtful whether this would extend to the nonbank holding company parent of an insured bank.

Right to Financial Privacy Act

The Right to Financial Privacy Act protects bank customers from the indiscriminate disclosure of their financial records by banks or government agencies. The Act applies to customers of all "banks," but fails to define the term (12 USC 3401(1)). Thus, it is unclear whether customer records held by nonbank banks are covered at all. Even if nonbank bank customers are covered, it is clear that the confidentiality of such records does not extend to transactions between a nonbank bank and its affiliates.

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In summary, there is considerable confusion over the scope of nonbank bank regulation and supervision, particularly over transactions between nonbank banks and their nonbank holding company owners. The bank regulators themselves do not have written uniform policies for supervising nonbank bank transactions with affiliates and have generally refrained from asserting their authority over unregulated corporations.

Meanwhile, the potential for abuse and risk to the FDIC and the payments system increases. In the debate over the future of nonbank banks, Congress and the public should keep in mind that nonbank banks and their owners are not regulated or supervised the same as full-service banks and that the agencies' authority over nonbank banks and their affiliates is largely unsettled.

Financial Factors

Introduction

400.0

The analysis of financial factors should be conducted in four primary parts, namely: (1) parent only, (2) banking subsidiary(ies), (3) nonbank subsidiary(ies), and (4) consolidated organization. In view of the fact that all BHCs are not structured in the same organizational and financial manner, it is important that examiners be flexible in their approach. There is no substitute for using sound judgment and creativity while performing an analysis, providing all of the pertinent information is available. The summary and conclusions should follow from the information presented in the analysis.

The analysis is intended to determine the financial strengths and weaknesses of an organization and the impact of conditions at the parent company and nonbank subsidiary which could adversely affect the condition of the banking subsidiary. As a regulatory agency, a goal of the Federal Reserve System is to safeguard and protect the soundness of commercial banks. The System oversees holding company banking and nonbanking activities to assure the continued safety and soundness of individual banks and the industry as a whole.

The analysis of financial factors resulting from the inspection of a bank holding company is essentially a finding of facts and an expression of judgment. In conducting an appraisal of a holding company's condition, the financial analysis of the organization based on a "building block" or "component" approach, should provide the examiner with a solid foundation from which to proceed. In order to complete the analysis it is first necessary to accumulate sufficient information concerning the parent company, bank and nonbanking subsidiary(ies) and the consolidated organization. A final analysis should not be attempted until these integral parts have been thoroughly reviewed.

The completion of the financial analysis will culminate with the preparation of a rating for the bank holding company. Manual section 407.0, entitled "Bank Holding Company Rating System," presents the rating system in its entirety.

ATTACHMENT C

BANKS RUSH TO SET UP SHOP IN WASHINGTON

They hope the District of Columbia's liberal banking laws will let them establish outposts less subject to regulation.

THE DISTRICT OF COLUMBIA has never been much of a financial mecca, but suddenly it has attracted some big names in banking. By early April four New York banks—Chase Manhattan, Morgan, Chemical, and Bankers Trust—had rushed to apply for approval to open new banks there. Five other institutions, including Greyhound Corp.'s finance subsidiary and Prescott Ball & Turben, a Cleveland brokerage firm, have also applied to run banks in the nation's capital. Most of the applications are to set up limited-service banks, sometimes called nonbank banks, which can offer commercial loans or checking accounts, but not both. What the bankers seem to be hoping is that the District's liberal banking laws will permit their limited-service banks to offer financial services forbidden to them elsewhere.

A Cleveland-based law firm, Squire Sanders & Dempsey, has been the principal promoter of the Washington banking opportunity; it represents all the outlanders that have applied to run banks in the District. The notion that a bank chartered there might be able to do things that a bank based elsewhere could not do is the idea of John Miller, an attorney in Squire Sanders' Washington office. Miller worked for the Comptroller of the Currency for 17 years, first as a bank examiner and later as acting chief counsel.

During his time with the agency, Miller researched the District of Columbia's banking laws. He discovered that they are less restrictive than those of most states. Theoretically, at least, a limited- or full-service bank in Washington that is a subsidiary of a U.S. bank holding company might be able to sell life insurance or act as a real estate broker, functions that states typically prohibit banks from performing. "No one really knows how far a bank can go because the law has never been fully utilized," says Dennis Gingold, a Squire Sanders lawyer who worked with Miller at the Comptroller's office and helped him unearth the opportunity in Washington.

Since Miller and Gingold joined the law firm last July, they have been passing the word to corporate clients about the banking climate in Washington. For bankers the area began to look even more attractive last fall when the District of Columbia Council joined a regional banking compact with 11 states in the Southeast. A limited-service bank can usually acquire other institutions more easily than a full-service bank; its purchases need not be approved by the Federal Reserve. An outfit that sets up a nonbank bank in Washington thus might be able to use it as a vehicle for acquiring other banks in the region. The rush to file quickly followed the council's move. Gingold maintains that his clients are more interested in the prospects for commercial lending in Washington than in the opportunity to offer new financial products or to branch out to nearby states. A Chase spokesman, on the other hand, says, "We would be interested in selling insurance anyplace."

John Miller *of Squire Sanders & Dempsey*

Since most of the District's banking laws have been around for 85 years, what was the banks' hurry to get approvals for new banks there? The reason for all the unbankerly haste was that on April 11 the District of Columbia took over from the Comptroller the job of approving local bank charters, and the banks wanted to make sure that their applications would be considered under the old system. The District council has tough community investment requirements that a newcomer has to satisfy. Any outside bank holding company that wants to do business there must acquire a local bank. A newcomer must also invest at least $50 million in the form of loans to local businesses or for real estate development in the District.

Naturally the law firm and its clients have not made many friends in Washington. Local bankers are opposed to having the behemoths from New York set up nonbank banks on their turf. Officials in the District government say that they have been undermined. "If the banks are going to benefit their affluent clientele, we want benefits for our residents who are not so affluent," says Councilwoman Charlene Drew Jarvis. She hints that the council may want to toughen the District's banking laws. **—Michael Rogers**

FANNIE'S BIG DEAL

Fannie Mae wants to sell $10 billion of securities to clean up its mortgage portfolio.

INTEREST RATES are the lowest in nine years and new home sales are going through the roof. For U.S. institutions in the business of issuing mortgages, this means a wild scramble to process applications and meet customer demand. For the Federal National Mortgage Association, the largest U.S. buyer of home mortgages, it means a frenetic effort to cover its fanny. The threat: a mismatch between the interest it earns on mortgages and what it has to pay out on its debt. Fannie Mae, which was set up by the federal government but is now owned by shareholders, has announced plans to dispose of $10 billion worth of assumable long-term fixed-rate mortgages by the end of 1986. The sale, if it goes through, will be the largest financial transaction ever completed in the U.S. other than corporate combinations.

Fannie Mae makes money three ways. It

A paper prepared by the American
Financial Services Association

The Regulation of Nonbank Banks

Opponents of nonbank banks frequently attempt to create the impression that nonbank banks are unregulated financial institutions. They argue that legislation is needed so that such limited purpose institutions will not be permitted to engage in such practices as providing loans and other financing to affiliates, lending to suppliers of affiliates, discriminating in extending credit, and engaging in unlawful tying practices. It is further argued that such institutions present risks to the payments system not presented by "regulated" institutions.

The truth, of course, is quite to the contrary, as many opponents know, or should know. Nonbank banks are fully regulated financial institutions, subject to all of the laws and regulations to which full-service banks are subject.

The following summary sets forth the principal regulatory and supervisory constraints applicable to both nonbank banks and full-service banks.

Examinations. Nonbank banks are regularly examined by the same state and federal banking authorities that examine full-service banks.

Affiliate Lending. Nonbank banks, just as full-service banks, are subject to section 23A of the Federal Reserve Act. This law restricts lending to any one affiliate to 10 percent of the bank's net worth, and limits lending to all affiliates in the aggregate to 20 percent of net worth. Purchases of assets from affiliates, investments in the securities of affiliates and guarantees issued on behalf of affiliates are also subject to these limits.

Even within these volume limits, loans to affiliates must be at least 100 percent collateralized, and all transactions with affiliates are required to be "consistent with safe and sound banking practices." Section 23A further restricts the purchase by a bank from an affiliate of a "low-quality" asset.

ATTACHMENT B

Sears Bank Accused of Forcing Developer to Buy Appliances

Special to the American Banker

Litigation

SAN DIEGO — An architect and developer has accused Sears, Roebuck and Co. of forcing him to install Sears Kenmore appliances and to use other Sears services in a condominium apartment project financed by the giant retailer's Sears Savings Bank subsidiary.

The architect-developer, Larry D. Hunts, and his wife, C. Jane Stradley, have filed a $100 million antitrust lawsuit in San Diego Superior Court against Sears and three subsidiaries. They charge that they were required to use the appliances and other Sears services in the 161-unit condominium project, Windsong Cove in Carlsbad, Calif., although cheaper and better services were available from other sources.

Sears denies any wrongdoing. A company spokesman characterized the lawsuit as a "run-of-the-mill commercial dispute concerning an alleged breach of contract between two sophisticated business entities."

Mr. Hunts and Ms. Stradley claim that they were co-owners in a joint venture arrangement with Sears Savings Bank to develop the project. But Sears also denies this, maintaining that it owned the project and had the right to select the appliances or any other services that were used.

The $7.1 billion-asset California-based Sears Savings Bank is part of the retailer's Dean Witter Financial Services Group, along with Dean Witter Reynolds Inc., the securities firm; Allstate Insurance Co.; and Coldwell Banker, the real estate brokerage firm. Sears Savings Bank, Coldwell Banker, and Allstate Escrow Inc., a division of Sears Savings Bank, are defendants in the lawsuit along with the parent company.

The lawsuit contends that Mr. Hunts and Ms. Stradley's general partnership, Papagayo Enterprises, was created in

Sears: Page 16 ➜

Sears Accused of Forcing California Developer to Buy Appliances

Continued from Page 1

1981 at Sears' insistence to enter into a joint venture agreement with Sears Savings Bank to develop the Windsong Cove project. However, Sears Savings Bank attorney Richard C. Fugate denies that there ever was a joint venture agreement.

The lawsuit, filed last year and amended in March to include an allegation of racketeering against Sears, charges that during several months of negotiations between February and June of 1981, Sears Savings Bank repeatedly indicated that it was planning to sign a joint venture agreement with Mr. Hunts and Ms. Stradley.

The suit says the couple agreed to take a discount on the sale of their land to the bank in exchange for 40% of the profits on the project.

Pending Foreclosure

Mr. Hunts had four lots, which were encumbered by multiple deeds of trust, and he was facing foreclosure on some of the lots. Sears Savings was not a lender on the deeds of trust.

The deal with Sears Savings Bank was scheduled to close on June 24, 1981, the day the lots would otherwise have been foreclosed upon. However, two days before the scheduled foreclosure, Frank Duda, Sears Savings Bank general counsel, allegedly met with Mr. Hunts and Ms. Stradley and presented them with a development agreement instead of a joint venture agreement.

This agreement substantially changed the couple's position vis a vis the bank from that of partner to that of agent and reduced their rights in the arrangement, the suit charges.

The lawsuit alleges that Mr. Duda — with knowledge of the pending foreclosure — told Mr. Hunts and Ms. Stradley that if the agreement was not signed then as presented to them, Sears Savings Bank would not purchase the property. Dennis C. O'Dorizzo of Schall, Boudreau and Gore Inc., Mr. Hunts' attorney, said that Sears took advantage of an "unfair bargaining position two days before the foreclosure."

Mr. O'Dorizzo and George A. Foster, an attorney with the same firm, contend that their clients could have made other arrangements if Sears had not waited until the last minute to tell them that they would be giving Sears a discount on their land in exchange for the job of developer instead of joint venture partner.

Mr. Fugate responded that Mr. Hunts is "an architect and a sophisticated person. He was about to lose his property to foreclosure. There were discussions on the terms on which he would sell the property to Sears. . . . We would deny there was any coercion or blackmail."

Once Papagayo signed the development agreement, the lawsuit paints a picture of Sears Savings Bank — holding tightly to the purse strings — unilaterally making numerous changes in the plans and specifications of the project over the protest of the developer. The changes caused cost overruns, delaying completion of the project over a three-year period, and wiping out Mr. Hunts' 40% profit, the lawsuit charges.

$20.5 Million in Loans

By the time Sears Savings Bank terminated its relationship with Papagayo on Oct. 3, 1984, it had lent $20.5 million through 14 different loan accounts to fund construction of the various phases of the project, Mr. O'Dorizzo said.

"Every one of the loans were made to Papagayo by the Bay Joint Venture or Papagayo Joint Venture," the attorney said. No other outside financing was used by Papagayo to construct, market or develop the condominium project, he said.

In August 1981, Sears Savings Bank informed Mr. Hunts that the appliances for the project were not to be put out for competitive bid but rather that Kenmore appliances were to be purchased from Sears, Roebuck and Co. instead and installed in the units, according to the suit.

Papagayo objected because the Kenmore appliances were not as appealing as the other amenities in the units, the lawsuit says.

After Kenmore appliances were installed in the first phase of construction, and potential buyers made negative comments about the Kenmore brand, Sears Savings Bank authorized Papagayo to install a different brand in the remaining units under construction, the suit charges.

However, Papagayo later was informed by the Sears Savings Bank senior project manager that a Kenmore sales manager employed by Sears Roebuck had complained about losing the business and that an official of Sears Savings Bank had demanded that Papagayo use Kenmore appliances.

So Kenmore appliances were installed, the lawsuit contends, at a higher cost and lower quality than the Caloric brand that Papagayo had found in the interim.

"We had the sovereign right as owner of the property and as the entity that hired Hunts as the developer to pick out amenities such as appliances," Mr. Fugate said.

Coldwell Banker Hired

In 1981, while Sears was in the process of acquiring Coldwell Banker, Papagayo began interviewing real estate brokerage firms to sell the units. Competitive bids ranged from 1.5% to 3% commissions, with Coldwell Banker coming in at 2%. George Charles Interests was contracted as the sales broker at a 1.75% commission.

However, in March 1983, Sears Savings Bank terminated the sales agreement with George Charles Interests and hired Coldwell Banker to market the units at a 3% commission rate, the lawsuit states.

On May 27, 1982, Sears Savings Bank sent a letter to Papagayo demanding that 100% of the escrow services in the sale of the units be conducted by Allstate Escrow, the lawsuit charges. Papagayo complied after informing Sears Savings Bank that its demand was in violation of California law, the suit alleges.

Papagayo contends in its suit that services provided by Allstate Escrow were inadequate, ineffective, and substantially more expensive than services provided by other escrow companies in the community.

Papagayo alleges that as a result of Sears' actions, its costs went up depleting the net profit available to Papagayo and resulted in additional profits to Sears.

The lawsuit alleges that on Oct. 3, 1984, Sears Savings Bank unilaterally terminated its agreement with Papagayo, claiming that the developer was 23% over budget and 21 months behind schedule.

Papagayo claims that it would not have been over budget if Sears had not changed the terms of the agreement and engaged in anticompetitive behavior. Also, Papagayo alleges, Sears controlled the pace of development through the purse strings.

"During 1982-83, the real estate market was very soft, so it was to Sears' benefit to delay construction until the market improved [in 1984]," attorney Foster said. "Sears was providing the money. Sears had the right to approve and negotiate all the contracts. Sears controlled what occurred."

Mr. O'Dorizzo said consumers who bought the Windsong Cove condominiums did not get the best value for their dollar because of Sears' alleged anticompetitive behavior. "The consumer is not best served by the 'family bank,' " he said.

Sears has proposed legislation creating a new category of "family bank" that could be owned by nonbanking entities such as Sears, Roebuck and Co. and concentrate on consumer loans. ■

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American Financial Services Association

August 12, 1986

Honorable Jake Garn
Chairman
Senate Committee on Banking,
  Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Re: The Regulation of Nonbank Banks

Dear Mr. Chairman:

Pursuant to your request, this letter is submitted by the American Financial Services Association (the "AFSA") in response to the Independent Bankers Association of America's ("IBAA") recent submission to the Senate Banking Committee (the "Committee") on the regulation of nonbank banks. As we demonstrate below, nonbank banks are, contrary to their portrayal by the IBAA and other nonbank bank opponents, fully regulated financial institutions.

Much of the controversy over nonbank banks stems directly from the increasingly vitriolic campaign waged by certain nonbank bank opponents to undermine public and Congressional confidence in the inherent safety and soundness of nonbank banks. The nature of this campaign is exemplified by the IBAA's submission to the Committee which, in its zeal to discredit nonbank banks as "half regulated entities under current law,"[1] simply ignores numerous federal statutes that grant the federal bank regulatory agencies (the "agencies") broad powers to supervise and regulate every aspect of a nonbank bank's relationship with its affiliates.

In view of the substantially misleading nature of the IBAA's submission, we appreciate this opportunity to provide the Committee with an accurate picture of the true regulatory environment in which nonbank banks operate.

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[1] IBAA submission at p. 1.

NONBANK BANKS ARE FULLY REGULATED FINANCIAL INSTITUTIONS

Nonbank bank opponents have frequently attempted to create the false impression that nonbank banks are unregulated financial institutions. In order to set the record straight on this issue, the AFSA recently prepared, and submitted to the Committee, a paper on "The Regulation of Nonbank Banks."[2] This paper described in some detail that nonbank banks are fully regulated financial institutions, subject to all of the laws and regulations to which full-service banks are subject.[3]

The AFSA paper apparently has forced the opponents of nonbank banks to concede somewhat begrudgingly that nonbank banks are themselves subject to the full panoply of statutes and regulations applicable to full-service banks, but the fury of their attack on nonbank banks has not diminished. Nonbank bank opponents now argue that, notwithstanding the full applicability of the aforementioned statutes and regulations to nonbank banks, such institutions "pose a significantly greater risk to the stability of our financial system than full-service banks"[4] because the Agencies are powerless to supervise and regulate transactions between nonbank banks and their owners.

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[2] A copy of the AFSA's paper is attached hereto.

[3] As noted by the AFSA paper, these laws and regulations include those governing affiliate lending; insider lending; lending on margin; capital adequacy; dividend limits; lending limits; access to the payments system; discount window advances; nonbank activities; changes in control; chartering and FDIC insurance; bank mergers; branching; management interlocks; tying arrangements; securities activities and affiliations with securities firms; consumer protection; and enforcement sanctions. AFSA's paper also noted that nonbank banks are subject to the Bank Protection Act, the Right to Financial Privacy Act, the Bank Secrecy Act and the Bank Bribery Act.

[4] IBAA submission at p. 1.

For example, the IBAA now contends that, although Section 23A of the Federal Reserve Act (12 U.S.C. § 371c)[5] is applicable to "covered transactions" between a nonbank bank and its parent,[6] the Agencies are unable to enforce Section 23A in the nonbank bank context because, according to the IBAA, the Agencies do not have authority to examine the owners of nonbank banks. Thus, the IBAA asks, "[h]ow is the FDIC supposed to accurately gauge the health of a nonbank bank if it can neither examine the nonbank bank's owner nor rely on the examination reports of the Federal Reserve?" IBAA submission at p. 3. Similarly, the IBAA asserts that Federal Reserve examiners are unable to monitor transactions between nonbank banks and their controlling owners. Id.

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[5] Section 23A of the Federal Reserve Act, which was originally enacted as part of the Banking Act of 1933, and was completely revised by the Banking Affiliates Act of 1982, is designed to protect all federally insured banks from abuses in transactions with their "affiliates." (The term "affiliates" as used in Section 23A includes controlling owners of nonbank banks.) Section 23A imposes two quantitative limitations on the amount of "covered transactions" (i.e., loans to affiliates and asset purchases from affiliates) that a bank or its subsidiaries may engage in with their affiliates. The first limitation restricts aggregate covered transactions with any single affiliate to no more than 10 percent of the bank's capital stock and surplus. The second restricts the aggregate amount of covered transactions with all affiliates combined to no more than 20 percent of the bank's capital stock and surplus. In addition to the aforementioned quantitative limitations, Section 23A(c)(1) mandates that "[e]ach loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a [FDIC insured] bank or its subsidiary shall be secured at the time of the transaction." Section 23A also includes an absolute ban against the purchase of "low-quality assets" by a bank or its subsidiaries from any of their affiliates. In addition, the Federal Reserve Board is authorized to "issue further regulations and orders, including definitions consistent with [Section 23A], as may be necessary to administer and carry out the purposes of [Section 23A] and to prevent evasions thereof." Section 23A(e)(1).

[6] Any loan or extension of credit made by a nonbank bank to any shareholder who owns, controls, or has the power to vote more than 10 percent of any class of the bank's voting securities would also be subject to the insider lending restrictions and reporting requirements imposed by 12 U.S.C. § 375b and 12 C.F.R. Part 215. See 12 C.F.R. § 337.3.

Not only are these assertions wrong, it is more than a little difficult to comprehend how the IBAA can in good faith argue that nonbank bank affiliates are immune from the Agencies' statutory examination authority in light of the fact that Congress first empowered the Agencies with examination authority over all bank affiliates more than 50 years ago in the Banking Act of 1933.

Under Section 5(c) of the Banking Act of 1933, 12 U.S.C. § 334, the Federal Reserve Board is authorized to require each member bank to "obtain from each of its affiliates[7] other than member banks and furnish to the Federal Reserve Bank of its district and to the Board of Governors of the Federal Reserve System not less than three reports during each year." These reports are required to "contain such information as in the judgment of the Board of Governors of the Federal Reserve System shall be necessary to disclose fully the relations between such affiliate and such bank and to enable the board to inform itself as to the effect of such relations upon the affairs of such bank." Id. (emphasis added). Section 334 further provides that "[a]ny such affiliated member bank may be required to obtain from any such affiliate such additional reports as in the opinion of its Federal Reserve bank or the Board of Governors of the Federal Reserve System may be necessary in order to obtain a full and complete knowledge of the condition of the affiliated member bank."

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[7] The term "affiliate" is defined by 12 U.S.C. § 221a(b) to include "any corporation, business trust, association, or other similar organization":

> "(4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 per centum of the number of shares voted for the election of directors of a member bank at the preceding election, or controls in any manner the election of a majority of the directors of a member bank, or for the benefit of whose shareholders or members all or substantially all the capital stock of a member bank is held by trustees."

The IBAA's submission to your Committee further fails to mention that the Federal Reserve Board is also authorized to conduct on-premises examinations of a member bank's affiliates. 12 U.S.C. § 338. Indeed, refusal to provide the Federal Reserve Board with any information requested during the course of such an affiliate examination may result in the member bank's expulsion from the Federal Reserve System. Id.[8]

Similarly, the Banking Act of 1933 vested the Comptroller of the Currency with comprehensive authority to examine and require reports of all national bank affiliates under penalty of charter forfeiture. 12 U.S.C. §§ 161(c)[9] & 481.[10] Finally, we note that the

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[8] 12 U.S.C. § 338 provides as follows:

"In connection with examinations of State member banks, examiners selected or approved by the Board of Governors of the Federal Reserve System shall make such examinations of the affairs of all affiliates of such banks as shall be necessary to disclose fully the relations between such banks and their affiliates and the effect of such relations upon the affairs of such banks. The expense of examination of affiliates of any State member bank may, in the discretion of the Board of Governors of the Federal Reserve System, be assessed against such bank and, when so assessed, shall be paid by such bank. In the event of the refusal to give any information requested in the course of the examination of any such affiliate, or in the event of the refusal to permit such examination, or in the event of the refusal to pay any expense so assessed, the Board of Governors of the Federal Reserve System may, in its discretion, require any or all State member banks affiliated with such affiliate to surrender their stock in the Federal Reserve bank and to forfeit all rights and privileges of membership in the Federal Reserve System, as provided in this subchapter."

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[9] 12 U.S.C. § 161(c) requires each national banking association to "obtain from each of its affiliates other than member banks and furnish to the Comptroller of the Currency not less than four reports during each year, in such form as the Comptroller may prescribe, verified by the oath or affirmation of the president or such other officer as may be designated by the board of directors of such affiliate to verify such reports, disclosing the information hereinafter provided for as of dates identical with those for which the Comptroller shall during such year require the reports of the condition of the association. Each such report of an affiliate shall be transmitted to the Comptroller at the same time as the corresponding report of the association, except that the Comptroller may, in his discretion, extend such time for good cause shown. Each such report shall contain such information as in the judgment of the Comptroller of the Currency shall be necessary to disclose fully the relations between such affiliate and such bank and to enable the Comptroller to inform himself as to the effect of such relations upon the affairs of such bank. The reports of such affiliates shall be published by the association under the same conditions as govern its own condition reports. The Comptroller shall also have power to call for additional reports with respect to any such affiliate whenever in his judgment the same are necessary in order to obtain a full and complete knowledge of the conditions of the association with which it is affiliated. Such additional reports shall be transmitted to the Comptroller of the Currency in such form as he may prescribe. Any such affiliated bank which fails to obtain and furnish any report required under this section shall be subject to a penalty of $100 for each day during which such failure continues."

[10] 12 U.S.C. § 481 provides:

"That in making the examination of any national bank the examiners shall include such an examination of the affairs of all of its affiliates other than member banks as shall be necessary to disclose fully the relations between such bank and such affiliates and the

[Footnote continued on next page]

FDIC is also authorized to "make such examinations of the affairs of all affiliates of [all FDIC-insured banks] as shall be necessary to disclose fully the relations between such banks and their affiliates and the effect of such relations upon such banks." 12 U.S.C. § 1820(b). Thus, contrary to the IBAA's assertion that the Agencies are powerless to examine the owners of nonbank banks, Congress long ago established a comprehensive regulatory structure through which the Agencies may supervise all aspects of a nonbank bank's relationships with all of its affiliates.

The Agencies' Enforcement Powers Extend to Nonbank Bank Affiliates

In the event that an examination of a nonbank bank or its affiliates were to disclose any questionable or unsafe and unsound transactions, the Agencies possess more than ample authority to take immediate corrective action. Although the IBAA asserts that "[i]t is doubtful whether [the Agencies' cease and desist powers] would extend to the nonbank holding company parent of an insured bank,"[11] the courts have ruled otherwise. For example, in Groos National Bank v. Comptroller of the Currency, 573 F.2d 889 (5th Cir. 1978), the court affirmed an order to cease and desist issued by the Comptroller of the Currency that prohibited credit and loan transactions between a national bank and its controlling owner. The order also prohibited the bank from accepting any deposit for the account of its controlling owner. The validity of this ruling is unquestionable in light of the fact that the Agencies' enforcement powers, including their powers to issue cease and desist orders and assess civil money penalties, expressly extend to all "person[s]

[Footnote continued from previous page]
effect of such relations upon the affairs of such bank; and in the event of the refusal to give any information required in the course of the examination of any such affiliate, or in the event of the refusal to permit such examination, all the rights, privileges, and franchises of the bank shall be subject to forfeiture in accordance with sections 141, 222 to 225, 281 to 283, 285, 286, 501a and 502 of this title." (Emphasis added.)

[11] IBAA submission at p. 7.

participating in the conduct of the affairs of . . . a bank." See, e.g., 12 U.S.C. § 1818(b)(1). In short, there simply is no basis for the IBAA's interpretation limiting the Agencies' enforcement powers with respect to a nonbank bank's dealings with its affiliates.

The Right to Financial Privacy Act Is Applicable to Nonbank Banks

The other examples of the purported "half regulation" of nonbank banks contained in the IBAA submission are equally spurious. For example, the IBAA suggests that the Right to Financial Privacy Act of 1978 (the "RFPA") does not extend to nonbank banks because the RFPA does not include a definition of the term "bank." IBAA submission at p. 7. This suggestion is meritless. The RFPA is applicable not only to banks, but to "financial institutions" generally, which term is defined by the RFPA to include banks, savings banks, card issuers, industrial loan companies, trust companies, savings and loans, building and loans, homestead associations, credit unions and consumer finance institutions. 12 U.S.C. § 3401. In light of the breadth of the Act's coverage, it is absurd even to suggest that a federally insured bank could somehow escape coverage by the RFPA simply by limiting the scope of its deposit taking or commercial lending activities.

Apparently recognizing the weakness of the aforementioned argument, the IBAA then suggests that "(e)ven if nonbank bank customers are covered [by the RFPA] it is clear that the confidentiality of such records does not extend to transactions between a nonbank bank and its affiliates." IBAA submission at page 7. This suggestion is also misleading because, as the IBAA is well aware, the RFPA is intended only to give individuals notice of, and a chance to challenge, federal government agency requests for a bank's records. Any restrictions on the disclosure of confidential customer records by a bank or a nonbank bank, other than to a federal government authority, must derive from sources other than the RFPA.

The Glass-Steagall Act is Applicable To Nonbank Banks

The IBAA argues that some nonbank bank owners have circumvented the restrictions of the Glass-Steagall

Act by acquiring nonbank banks that are not members of the Federal Reserve System. IBAA submission at p. 6. However, the IBAA's quarrel here is not with nonbank banks and their owners, but with the fundamental structure of the Glass-Steagall Act. In Investment Company Institute v. Federal Deposit Insurance Corporation, 606 F. Supp. 683 (D.D.C. 1985), the court held that Section 21 of the Glass-Steagall Act, which is the only section of the Act applicable to state-chartered, nonmember banks:

> "was not intended to bar securities activities by subsidiaries or affiliates of insured non-member state banks. While Congress recognized the possible evils involved in such affiliations, it expressly addressed them in other sections of the Act but deliberately chose not to intrude upon state nonmember banks in this respect." Id at 686.

Thus, this perceived "loophole" in the Glass-Steagall Act, through which nonmember banks may affiliate with securities firms, is equally available to full and limited purpose banks. Therefore, the banning of nonbank banks would do nothing to close this loophole because state-chartered, nonmember banks would continue to be free to affiliate with securities firms.

Nonbank Banks Are Prohibited from Engaging in Anticompetitive Tying Arrangements

The IBAA suggests that nonbank banks and their owners are free to engage in anticompetitive tying arrangements. Again, the IBAA is wrong. Nonbank banks and their owners are subject to those federal antitrust laws, including section 3 of the Clayton Act and section 1 of the Sherman Act, that prohibit anticompetitive tying arrangements and that provide treble-damage and injunctive remedies for violations.

Nonbank Banks Are Subject to the Federal Reserve Board's Supervision of the Payments System

The IBAA states that "[a]ll full-service banks and bank holding companies that have access to the Federal Reserve payments system are subject to check collection and wire transfer procedures and to close regulatory supervision." IBAA submission at p. 6. It then goes on to assert that "[n]on banks and their parents are not fully subject to the Federal Reserve's supervision of the payments system." Id. Once again, there is no basis for the IBAA's attempt to characterize nonbank banks as "half-regulated" entities. The IBAA's assertion that bank holding companies that have access to the payment system are subject to more rigorous regulatory supervision than the parents of nonbank banks is plainly wrong in light of the fact that neither type of entity is even entitled to access the payment system. Such access generally is limited to depository institutions and clearing institutions. See Federal Reserve Board Regulation J, 12 C.F.R. Part 210. Furthermore, Regulation J, which governs the Federal Reserve Board's administration of the payments system, makes no distinction between the different types of depository institutions entitled to access the system. Id. Thus, all institutions entitled to participate in the payments system, including banks and nonbank banks, are subject to the same level of supervision.

* * *

We have attempted to respond herein to some of the IBAA's more serious misrepresentations and omissions concerning the regulation of nonbank banks and their affiliates. We are confident that this letter will establish to your satisfaction and the satisfaction of your Committee that nonbank banks truly are fully regulated financial institutions subject to all of the laws and regulations to which full service banks are subject, and that their continued operation in this regulated environment is consistent with a safe and sound banking system.

Sincerely,

Robert B. Evans

A loan made to a third party where the proceeds are used for the benefit of an affiliate or are transferred to an affiliate, is deemed to be a loan to the affiliate itself and is subject to section 23A limits. There is, therefore, no greater risk that nonbank banks will be used to advance the interests of affiliates than in the case of full-service banks.

Insider Lending. Nonbank banks are subject to all of the same limits as full-service banks imposed by section 22 of the Federal Reserve Act and the Fed's Regulation O on loans to executive officers, principal shareholders and entities controlled by such persons. The aggregate of all loans to any such person and his related entities cannot exceed the bank's limit on loans to a single borrower. Loans to such persons and entities, as well as loans to directors, cannot exceed $25,000 absent special approval by the bank's board, and all such loans are required to be nondiscriminatory, in terms of interest rates, collateral and payment risk, as compared to loans to persons unrelated to the bank.

Margin Regulations. Nonbank banks are subject to the same margin rules (Regulation U)—that is, rules relating to lending for the purchase of securities—as are full-service banks.

Reserve Requirements and Deposit Interest Rate Controls. Nonbank banks are subject to the same reserve requirements (Regulation D) and deposit interest rate limits (Regulation Q), as full-service banks.

Capital Adequacy. Nonbank banks are subject to the same capital requirements and guidelines as full-service banks, and are fully subject to the authority of the federal bank regulators under the International Lending Supervision Act of 1983 to set and enforce levels of capital adequacy for individual banks.

Dividend Limits. Nonbank banks may only pay dividends to their shareholders under the same circumstances as full-service banks may pay dividends.

Lending Limits. Nonbank banks are subject to the same limitations on loans to a single borrower as full-service banks.

Payments System. Nonbank banks are fully subject to the Federal Reserve's Regulation J, which governs check collection and wire transfer procedures.

Discount Window Advances. Nonbank banks are not permitted access to the Federal Reserve discount window except on the same terms and conditions as full-service banks.

"Nonbank" Activities. Nonbank banks may not engage directly or through subsidiaries in any activities that would be prohibited to their full-service counterparts under state or federal law.

Changes in Control. The acquisition of nonbank banks is subject to extensive regulation. No person or company may acquire a nonbank bank without full scrutiny by a federal bank regulator. Under the Change in Bank Control Act, the federal authority may deny permission to acquire such a limited purpose bank if it finds (a) that the financial condition of the acquiring entity might jeopardize the financial stability of the bank or prejudice the interests of depositors; (b) that the competence, experience or integrity of the acquiring entity is such that it would not be in the interests of depositors or the public to permit the acquisition; or (c) that relevant antitrust standards would be violated. These are the same standards applicable under the Change in Bank Control Act to acquisitions of full-service banks.

Chartering and FDIC Insurance. Any person or company that proposes to charter a nonbank bank, or to obtain federal deposit insurance for such a bank, must satisfy all of the financial, managerial and other standards as are applicable to full-service banks. Once FDIC insurance is granted, nonbank banks pay the same premiums, and are subject to the same assessments, as full-service banks.

Bank Merger Act. Any merger involving a nonbank bank is subject to scrutiny on antitrust grounds, both by a federal banking agency and by the Department of Justice.

Branching. Nonbank banks are subject to the same state and federal limitations on branching as are full-service banks.

Management Interlocks. Officers, directors and employees of nonbank banks are subject to the same limits on interlocking service with other depository institutions as their counterparts in full-service banks.

Unlawful Tying Practices. Nonbank banks are subject to those federal antitrust laws, including section 3 of the Clayton Act and Section 1 of the Sherman Act, that prohibit anticompetitive tying arrangements and that provide treble-damage and injunctive remedies for violations.

Glass-Steagall Act. Nonbank banks are subject to the same limits on securities activities, and interlocks and affiliations with securities firms, as full-service banks.

Consumer Protection Laws. Nonbank banks are fully subject to all of the following consumer protection measures to the same extent as full-service banks:

- Truth-in-Lending
- Truth-in-Leasing
- Equal Credit Opportunity Act
- Home Mortgage Disclosure Act
- Community Reinvestment Act
- Fair Credit Billing Act
- Federal Trade Commission Improvement Act (unfair and deceptive practices)
- Fair Housing Act
- Fair Debt Collection Practices Act
- Fair Credit Reporting Act
- Electronic Funds Transfer Act
- State and federal usury laws
- Real Estate Settlement Procedures Act

Enforcement Sanctions. Nonbank banks are as susceptible as full-service banks to the powers of banking regulators to issue cease-and-desist and removal orders and to impose civil money penalties for violations of laws and regulations.

Bank Protection. Nonbank banks are fully subject to the provisions of the Bank Protection Act of 1968, which sets out minimum standards for bank security systems.

Right to Privacy. Nonbank banks are fully subject to the Right to Financial Privacy Act of 1978.

Bank Secrecy Act. Nonbank banks are fully subject to the provisions of the Bank Secrecy Act, which establishes reporting and recordkeeping requirements relating to currency transactions.

Bank Bribery Act. Nonbank banks are fully subject to the provisions of the Bank Bribery Act prohibiting payments and gratuities to bank employees in connection with bank business.

What banking laws applicable to full-service banks are *not* applicable to nonbank banks? None, that we are aware of. The *only* difference between full-service banks and nonbank banks relates to certain restrictions on the *owners* of such institutions. Those provisions of the Bank Holding Company Act that limit the nonbanking activities of corporate owners of full-service banks, and that limit the ability of bank holding companies to own full-service banks in more than one state, are inapplicable to owners of nonbank banks. As is apparent, however, with these exceptions, nonbank banks are subject to all of the same federal laws and regulations as are full-service banks. There is no basis whatsoever for any suggestion that nonbank banks will be any more likely to violate such laws or regulations or that nonbank banks will be operated any less prudently than their full-service counterparts.

The CHAIRMAN. Mr. Doyle, in the history of banking regulation in this country up to 1956, are you aware whether any company was ever prevented from owning a bank up until 1956 when the Bank Holding Company Act was passed?

Mr. DOYLE. I do not know of any. I am not familiar with that, so I couldn't respond to that.

The CHAIRMAN. Are any of you aware?

Mr. PETTY. I think there are many State prohibitions against it that would have pertained.

The CHAIRMAN. I'm speaking at the national level. I am not aware that they were prevented. One of the purposes of the Bank Holding Company Act was to do that and whether you have any opinions on whether the purpose of that was stimulated to break up Trans-America or to prevent abuses from companies or businesses or labor unions owning ownership of banks. In other words, I'm trying to get the historical perspective of the Bank Holding Company Act, what motivated its passage and what we were doing prior to it. No volunteers?

Mr. DOYLE. Are you talking about the Douglas amendment and the reason for the amendment?

The CHAIRMAN. I'm speaking of the Bank Holding Company Act in 1956. What I'm trying to get at is to put in this some historical context of what we are attempting to deal with, what went on prior to 1956 and why, what the motivation was at that time, and what the concerns were, because a lot of people seem to think that there's always been preventions and that never could other businesses own a bank. That is not the case, but apparently we are all too young to remember prior to 1956.

Mr. DOYLE. Well, I'll be happy to speak to what my understanding was. My understanding was that at that time no State had any provisions whereby someone could come across State lines and to acquire their financial institutions. Therefore, Senator Douglas put the amendment in to give the power to the States to prevent across State line purchases of their banking institutions as they had developed their banking structure within the State.

The CHAIRMAN. Now you're speaking specifically of the Douglas amendment rather than the Bank Holding Company Act itself. In other words, I'm asking a broader question.

Mr. DOYLE. I'm sorry. The whole purpose of why we wanted to control who could own a bank is the question that you're wanting us to respond to?

The CHAIRMAN. Yes, break up Trans-America, prevent abuses—you're dealing specifically with the interstate part of it. I'm asking the more general question of the motivation in general of why we wanted to keep businesses or labor unions, or companies from owning banking institutions.

Mr. DOYLE. Well, the whole issue of separation of commerce and banking probably, in my opinion, was the motivating force that would cause that type of thing because of the capability of a holding company to grow unlimitedly. It was the source of capital that they could accumulate with a large base of investors and a large marketplace provided by your sophisticated New York financiers that could provide the capital to acquire on a much more broader basis than had ever existed before through the holding company technique. Therefore, they saw the possible demise of a decentralized system that could take place.

Mr. PETTY. There was pressure also to make sure there's adequate supervision of banks if they got into the area of nonbanking activities which was beginning to grow in their ambitions at that time.

The CHAIRMAN. Mr. Doyle, do you have any idea or even rough idea of what percentage of independent banks are owned by individuals that own other commercial businesses?

Mr. DOYLE. No, I couldn't address that. I know that where you find an individual banker that owns the bank, like the chairman of the board and owns control of the bank, they had accumulated wealth in one way or another from some other source over their background, but there are a lot of individuals like me that did not have that type of background who on a local basis put together individual businessmen or a variety of businessmen and women who invested in the bank with someone like myself who was the bank owner-operator. There are an awful lot of those, but I wouldn't have any idea the percentage breakdown in the industry today as how it would relate.

POSSIBLE CONFLICT OF INTEREST

The CHAIRMAN. Well, do you think we ought to prohibit individuals who own a majority interest in a different type of commercial enterprise from owning a majority interest in a bank?

Mr. DOYLE. If it conflicts with their ownership of the bank, yes, sir, I do.

The CHAIRMAN. Well, how do you define that?

Mr. DOYLE. Well, I think as a corporate opportunity. If I'm an executive of a bank and operate that bank, I have to operate that bank for the best interests of the shareholders of that bank, whether I might have an interest personally in any other type of endeavor in the community or not.

The CHAIRMAN. What about an automobile dealer who owns an automobile dealership and owns a bank. Is that a conflict?

Mr. DOYLE. For an automobile dealer to own a bank?

The CHAIRMAN. The point I'm trying to make is there's a lot of blurring here. We stick to the Bank Holding Company Act and we hear a lot of testimony on how we ought to prohibit this and how we ought to prohibit that, and I don't know what the percentage is either, but there's certainly a lot of intermixing out there that doesn't fit under the Bank Holding Company Act or the Douglas amendment or anything else between people who own other types of businesses, majority owners, and own banks as well. I'm just simply saying isn't that just as bad as some of the other things that we're saying?

Mr. DOYLE. It could be, because, again, you have to ask yourself the question: Is that automobile dealer tying his automobile dealership with the operation of the bank? Is he giving special financing arrangements to those who might buy automobiles from his dealership than he would from you if you had the dealership down the block and had no interest in the bank.

The CHAIRMAN. But all of that is legal right now. There are no laws or prohibitions that prevent that, is there?

Mr. DOYLE. Well, there are laws that prevent tying, yes, sir, and to prevent the taking of corporate opportunity, and we have been embarrassed by a lot of bankers who have done that over these past years.

The CHAIRMAN. There are a lot of laws to prevent tie-in sales in insurance but I can't convince the independent insurance agents that banks don't do that. Mr. Petty, you had a response you wished to make?

Mr. PETTY. I'm going to differ from Mr. Doyle's response and say that I would not see a need to regulate that. I don't think there's evidence of abuse of it and I think, furthermore, that there's already existing legislation quite clear in the regulators' hands to protect against tying and any other illegal activities.

The CHAIRMAN. Mr. Rideout, as you know, the House Banking Committee attached so-called consumer and anticompetition safeguards in H.R. 2707 which is a regional interstate banking bill that apparently the Association of Bank Holding Companies supports. Should these matters be considered in conjunction with this bill or are they concerns that are appropriately addressed under current law?

Mr. RIDEOUT. We have not specifically looked at the question of this particular bill on emergency interstate powers for the regulators in conjunction with those specific legislative provisions that are pending in the House of Representatives. It's something however that we have studied and oppose, and I would think that given the urgency for action with respect to this particular legislation that that House legislation would be a bit cumbersome and so I guess my answer would be no. I think they certainly should be separated and perhaps those can be addressed in another forum.

LIMITATIONS ON OUT-OF-STATE ACQUIRERS

The CHAIRMAN. Mr. Petty, Chairman Volcker pointed out in his testimony yesterday that under S. 2372 an out-of-State acquirer of a bank or a bank holding company would have to have its subsequent expansion rights limited to the three largest metropolitan areas or cities within the State.

While the regulators view this as a limitation, how do you react to that recommendation, specifically as it relates to override of States' rights to determine their intrastate branching laws.

Mr. PETTY. I think there's some ambiguity in the wording as it's now drafted as I get different interpretations of the provision of that bill. I think that the bank that comes in after going through the procedures permitting local banks to bid first, et cetera, that that out-of-State banker should be given the same rights to operate in the new marketplace that indigenous banks have in that marketplace.

The CHAIRMAN. Mr. Doyle, how do you feel about that? They say it's a limitation. You're concerned about it. I assume you would assume it's not enough of a limitation.

Mr. DOYLE. Well, we feel that the State should control the type of expansion that the new entrant into the market would be permitted to have and to us that's part of the dual banking system question. It's up to that State to determine the expansion rights of the new entrant into the marketplace. It shouldn't be just granted by a Federal law of some type that would give him certain permission to expand in any way in a State that would be contrary to the State's law.

The CHAIRMAN. Even if FDIC insurance is being provided?

Mr. DOYLE. Yes, sir.

The CHAIRMAN. How do you rationalize that? As all of you know, all the time I've been on this committee I represent a small State and I've been a defender of States' rights, not only in banking issues but over and over again. But if we have a case of Federal funds, FDIC or FSLIC, available, what you find is that in many of the troubled institutions, particularly in the thrifts, getting away from independent banks for a moment, they have been State-chartered institutions that have been allowed powers far, far beyond what has been allowed by the Feds, mushroom farms, and so on. Even though I am a States' rights person, should I be sitting here risking the FSLIC fund or the FDIC fund over States deciding to let various institutions get into mushroom farms and other things that I consider are too risky for a depository institution?

That's where I have to start drawing a line and say, "OK, you don't like us interferring." And I would generally agree. I used to be a mayor. I got tired of the Feds telling me what to do, but on the other hand, I've got a responsibility and the Senate does, to make sure that the FDIC and the FSLIC remain solvent.

Mr. DOYLE. Well, I wouldn't argue with that. I think that if it is clearly a threat, whatever the institution is doing, to the safety and soundness of the institution, whatever engagement of activity it may be in, if it can clearly be declared that an activity is a threat to the fund, then I think that the FDIC should have the authority to withdraw the insurance under those kinds of situations, where the engagement of an activity is a threat to the fund.

The CHAIRMAN. You see the regulators——

Mr. DOYLE. The fact that they couldn't go from Dallas to Fort Worth isn't a threat to the fund. I mean, they can run a profitable bank in Dallas. I run one in Texas City. So why should they have to have the right to go to Amarillo, Plainville, and San Antonio? Why shouldn't they operate the bank in the marketplace it is serving right now and do it properly?

The CHAIRMAN. Well, the regulators' position is, in placing a limitation of three is to get you people on board. That is a political decision. It isn't an economic decision at all. It is a political decision designed to get the Conference of State Bank Supervisors support. It obviously failed, but it is the only reason for that limitation. It isn't a matter of safety and soundness or anything else.

Mr. DOYLE. But it violates the principle. And that is why we're hanging in there. We think that the point is: If they are going to violate the State law by allowing them to come in in the first place, then we say don't violate the State law any more than you have to. And if they can own a bank in Houston, which is a darn good economy and a marketplace to operate in normally—it's down a little now, but it will come back—then they can make money operating that bank in Houston. They don't have to go to these other cities that they're asking for.

The CHAIRMAN. Senator Riegle.

NONBANK BANK STATUS

Senator RIEGLE. Mr. Chairman, I have been enjoying your questions and I would like to follow up on one of the basic issues that you raised, namely why shouldn't any institution be allowed to own a bank and why is it so important to most of the members of the panel, at least three out of four of you, that we take action to close the nonbank bank loophole. I would like all four of you to respond to the very basic question of why any institution should not be allowed to own a bank?

Why don't we just start with you, Mr. Rideout?

Mr. RIDEOUT. Well, just a general observation with respect to the whole nonbank bank concept, and that is that nonbanks, in effect, as I understand the concept and the way it works, would be able to establish limited purpose banks, but also, they would be able to offer through those nonbank banks other kinds of financial services which currently banking is prohibited from offering to its basic marketplace. It seems to me that that is one of the primary concepts here that needs to be controlled.

Senator RIEGLE. Let me just make sure I understand that, and then I am going to have you add anything else you want to it.

Your concern is that somebody would use the nonbank bank, bank loophole, set up a limited service bank, but then be free to offer other products and services that you would not be able to offer as a traditional bank. So it is a competitive threat that you see? Am I restating properly what I think I heard you say?

Mr. RIDEOUT. Let me see if I can clarify that somewhat. A nonbank, through this nonbank loophole, would, in theory, be able to establish outlets. It would be able to establish a delivery system around the country. It would be able to establish a delivery system on an interstate basis and would be able to offer, as I understand it, certain limited banking powers. As I understand it, you can offer either commercial loans or demand deposits, but you can't offer both. So there's some restrictions, in terms of the basic banking powers that can be offered. But additionally, as I understand the concept, a nonbank financial services company, a Sears, Roebuck or someone else, who is offering other kinds of financial services—insurance, real estate services, whatever it might be—could use that delivery system to, in effect, offer those services to a much broader marketplace, as well.

Senator RIEGLE. But why does that bother you?

EXPANDED SERVICES FOR BANKS

Mr. RIDEOUT. Well, it only bothers us in the sense that banks are not permitted to offer those products, those kinds of services. In other words, we're not allowed to be, at this point, in real estate brokerage or in the insurance agency business of one kind or another. These are subjects which, as I understand, that the chairman and the members of this committee are going to be considering in the very near future, in terms of expanded powers for banks.

Senator RIEGLE. Do you have any other objection, other than that the competitive pressure that that obviously brings, where you've got somebody that is a quasi-bank, they do some banking functions, and then they have this other line of products that you can't have? Is there anything else about the nonbank bank that you find objectionable?

Mr. RIDEOUT. I think it is essentially a competitive equity issue, and that is, I think, the main concern that banking has with the concept.

Senator RIEGLE. If you could offer the same products, then you would be prepared to live with the nonbank bank?

Mr. RIDEOUT. Well, that is something that I personally am going to have to think about. I think that one of the things that's very important to our industry, to the commercial banking industry right now is expanded powers, but there also is this question of the delivery system and the consistency of the delivery system, in terms of nonbank competitors and bank competitors. I think that is something that we've discussed, and we would be happy to submit a statement to you on that for the record.

[The following information was subsequently supplied for the record.]

The American Bankers Association has no objection to allowing other financial type corporations to compete in the banking business, so long as the competition occurs on the same ground rules for all parties. Our principle objection with regard to nonbank-banks is that the parent companies of such organizations are not regulated as are bank holding companies. It seems inappropriate to allow some financial companies to own banks totally free of the regulation of the Federal Reserve Board under the Bank Holding Company Act while others are subject to Federal Reserve regulation, examination, and supervision. We would, therefore, urge that the Bank Holding Company Act be amended to clarify that only those organizations engaged in businesses in which bank holding companies can engage could own banks.

Senator RIEGLE. Are there any concentration of power problems that you worry about, that really big players would come in in this fashion, and even if you had the competing products, you'd find that there might be a concentration issue taking place that would pose problems for banks that you represent?

Mr. RIDEOUT. I wouldn't say at this point in time that the banking industry is concerned about a concentration problem vis-a-vis nonbank financial services companies, in terms of a competitive threat. I don't think there is a particularly difficult problem there. I think the problem has to do with having the powers to compete. I think bankers feel that if they have the powers to compete, they can compete very effectively.

Senator RIEGLE. Mr. Doyle, what are your thoughts?

Mr. DOYLE. Well, I would like the opportunity to respond in writing too, because I don't have time to really go through all my thoughts on that, but I'll hit the highlights.

[The following information was subsequently supplied for the record:]

IBAA
INDEPENDENT BANKERS
ASSOCIATION OF AMERICA

MEMORANDUM

From ... WASHINGTON OFFICE

The following responds to Senator Riegle's question, "If banks were given the same powers as nonbank banks, would there still be a problem with the existence of nonbank banks?"

I do not believe that granting new powers to banks is the answer to the problems posed by nonbank banks. Nonbank banks create problems that go far beyond competitive inequities between them and traditional banks.

Nonbank banks create the possibility of undue concentration of financial resources by money center banks and corporate giants. It breaks down the existing limitations on interstate deposit-taking and bank ownership in the McFadden Act and Douglas Amendment to the Bank Holding Company Act. These limitations were not put in place to protect small banks, but to insure a diverse and competitive marketplace. Nonbank banks open the possibility for eventual domination of the banking system by the Fortune 500 companies.

Second, nonbank banks are only half-regulated. For a further elaboration of this point, I refer you to a June 4, 1986 letter I wrote to Chairman Garn for the record.

The safety and soundness of the banking system is further undermined by the fact that nonbank banks abuse the Federal deposit insurance system. Commercial corporations using nonbank banks or thrifts to obtain insured deposit-taking capability clearly threatens the separation of banking and commerce and the competitive position of free-standing banks and thrifts. The federal deposit insurance safety net was never intended to support ordinary commercial enterprises. The federal government should not, through the deposit insurance system, guarantee the solvency of every commercial enterprise that decides to buy a bank.

The last point that I would like to make concerns the instability nonbanks banks could cause to the payments system. For further elaboration of this point, I will direct you to the enclosed pages excerpted from testimony I submitted to the House Committee on Government Operations on September 18, 1986.

As you can see from this summary of our views on nonbank banks, our concern stems from more than the differences between the powers enjoyed by nonbank banks and their competitors. While we support granting new powers for banks, that is not the answer to the nonbank bank issue.

We think the most practical course would be to eliminate the loophole which enables commercial firms to establish their own federally-insured banking system without Congressional approval. Closing the loophole would not prevent consumers from obtaining needed services or greatly reduce competition. Financial services that do not present the conflict of interest problems could be combined, and others would continue to be widely offered by independent firms.

We believe that closing the loophole will actually preserve competition, since that would help prevent the establishment of a banking system dominated by money center banks and Fortune 500 commercial firms. These giants could become "financial supermarkets;" squeezing locally owned banks into the periphery of the marketplace.

D. PAYMENTS SYSTEM ACCESS

It is hard to overestimate the importance of the payments system to our nation's economy. A reliable payments system is crucial to economic growth and stability. It is a tribute to the skill and dedication of the Federal Reserve and the other participants that the system works so well that most Americans simply take it for granted.

The Federal Reserve's efforts to control risk on large dollar payments networks is an example of the ongoing work to preserve the integrity of the payment system. Nevertheless, the payments system is exposed to a considerable degree of risk every day. For example, on the Federal Reserve's wire transfer system (Fedwire) all transfers are final and irrevocable when the Reserve Bank sends notice of the payment to the receiving bank. The receiving bank can pass collected funds immediately to its customer without concern for the sending bank's reserve position. If the sending bank has insufficient funds in its reserve account at the time the payment order is initiated, it incurs a daylight overdraft. It is the sending bank's responsibility to bring its reserve account into balance by the end of the day.

Serious problems could arise if a depository institution incurred a large daylight overdraft which it could not cover by the end of the day. This is not just a theoretical concern. As you know, earlier this year the computer program that controled securities transfers for a major New York bank failed. This resulted in a multi-billion dollar overdraft in this bank's reserve account. The Federal Reserve Bank of New York had to loan that bank billions of dollars to preserve the integrity of the system.

In that case the system was disrupted by a computer glitch; the bank was ultimately good for the funds. But what if an overdraft could not be covered because the bank failed, or i parent or an affiliate went bankrupt? The Federal Reserve mig have to absorb substantial losses. IBAA believes it is essential that the Federal Reserve have the authority to deal with these potentially costly situations by prohibiting access to the payments system if necessary to ensure the safety and soundness of the payments system.

Community bankers believe that nonbank banks owned by commercial firms not subject to regulatory oversight pose a special threat to the system. At this time, these nonbank banks are, for the most part, not large, but many of their parent companies rank among the Fortune 500. We are concerned that a nonbank bank could incur overdrafts on behalf of its parent company or an affiliate which the nonbank bank could not cover with its own resources. As in any credit situation, the credit grantor must rely on the capital position of the borrower. In this kind of case, the Federal Reserve regulates only the direct participant in the system the commercial firm's parent and its resources, are beyond the Federal Reserve's regulatory authority.

Senator RIEGLE. We're probably going to be around here until maybe 10 p.m., tonight anyway. [Laughter.]

So maybe we can get quite a way into it.

Mr. DOYLE. Well, to begin with, my concern, as far as the regulators bill is concerned—and I will address that first—is the fact that it doesn't make any sense to me. If you are trying to secure buyers because you don't have buyers in a State for an institution, because it is in some sort of financial trouble, it doesn't make any sense to allow potential buyers to come into that market through the nonbank bank loophole, which allows a specialized kind of financial institution to operate what some call "consumer banks" and other things. It is a special purpose institution, and it is my understanding that we have been trying to move away from special purpose institutions, but at the same time preserve a decentralized banking system.

So my point is, why would we want to allow a new entrant into Texas—I will use my own State as an example—where we have applications in every one of our major cities for nonbank banks of all kinds by all sources, some foreign even, and, at the same time, say to the bankers in the State, "Look, we've got to void your State law in order to find some new ways to have buyers for your banks that are failing, because you folks can't buy them down here."

That, to me, is contradictory.

OBLIGATIONS OF BANKS TO THE COMMUNITY

Now why am I against nonbank banks period? There's a whole lot of reasons. No. 1, it seems to me that when we talk about needing a Community Reinvestment Act [CRA], which Congress adopted, you were concerned, I assume, that banks were not meeting their obligations to their local communities. They were not meeting the financial needs. They were not meeting the needs of the local consumer. They were not meeting the needs of the local mayors. They were not meeting the needs of the local car dealers or farmers.

So we are going to tell you folks, "if you are going to take the deposits there, you've got an obligation." That is what the CRA, as I understand it, says. I have to post it in my lobby and tell people that and tell them that I am going to commit to make my loans in my market area. I am going to put that money back to work there. That is a commitment I have to make under the CRA.

Senator RIEGLE. You think the nonbank bank wouldn't do that?

Mr. DOYLE. They do not do that. How can they do that? They have either got to accept loans, or they have to accept deposits, and they found that as a loophole to go around the laws and the policies that you have set. As long as we leave it open, they don't care what Congress' policy is. They set their own, because they use the loophole technique to get there.

Senator RIEGLE. What would be the next thing on your list?

Mr. DOYLE. The next thing on my list is who determines the type of institution it will be and the policies that it is going to operate under? Who are the folks that are going to do that? Are they going to live in New York City, Hong Kong? Are they going to live in Utah or Texas? Where are they going to live? And who are they going to be? Are they going to be people from that community, the farmers, the housewives, the businessmen, who are going to sit there on the boards of directors? They're going to be the owners of the institution, have their money at risk, and so they are going to look at it from that point of view and make policy decisions as to what kinds of loans this bank is going to make. What is going to be its long-term future and how is it going to plan to serve its community, whether the community is in a small area like Texas City or a county like Galveston County or a region like the Houston-Galveston area or the State of Texas or some of the regional banking pacts that we have?

As you move away from that local area, the priority of needs changes, and one of the things that I am concerned about is that if it is a money center bank, their priorities begin at the opposite end of my scale. Their priorities are going to be to look at where they can make the most money on international loans and on national-type lenders and borrowing with national-type firms.

I don't loan to those kind of people. I begin with my local community and those kind of people. Then when I've met their needs, then I go to the State level and I buy bonds or investments in the State or participation loans on the State level. And then later on, I will invest in other institutions.

So I move from the grassroots up in my allocation and sensitivity of priorities. They move from the top level down. They are great at taking deposits out of our communities, but it is very difficult for them to bring those same deposits back down to that small businessman. That is why 75 percent of the loans that are being made, go to the smaller businessmen, the 700,000 new businesses being formed today. Our economy today is being rebuilt by the grassroots, not the Fortune 500. It is the little guys. What is happening is that we reallocate those funds to the 75 percent who are those small businessmen.

The money center and regional banks don't do that. They have a much smaller percentage of their loan portfolio addressing that situation.

Senator **Riegle**. I want to get to the rest of your answer and maybe Senator Gramm would be interested in it too.

Senator **Gramm**. No, I won't.

CONCENTRATION OF BANK ASSETS

Mr. **Doyle**. But there is one final thing and that is concentration, the threat to the fund—we are here talking about the threat to the fund. Now we are saying that we are going to allow concentration to take place through skimming by Sears and all the other people, taking the goodies out of the communities and focusing them all in Chicago, where they have a big building and make decisions on a broad national scale, and at the same time concentrating assets and building more and more billion dollar institutions that are going to be covered by the depository fund.

Now we can have a lot of million dollar institutions fail, but we can't have many billion dollar institutions fail. We found that out in Continental.

So what I am saying is, if we allow that concentration to take place, then we increase the threat to our fund, and in the last 2 years, they've doubled the number of billion dollar banks. From 1984-85, we've doubled the number of banks that were in that category of $1 billion or more. It is really—even without some of the things we have asked for, concentration is taking place.

Senator RIEGLE. Mr. Chairman, I know my time is up. I know Mr. Petty would like to make a rebuttal, and I know Mr. Malarkey would like to.

We haven't heard from Mr. Malarkey, and I am just wondering if we could at least let them finish those answers in some kind of an orderly sequence, particularly because it was your question to start with and I just wanted [laughter]; I'm just taking a ride on your question.

The CHAIRMAN. Well, I don't have any objection to them finishing if Senator Gramm doesn't have any time constraints.

Senator GRAMM. If they could be succinct.

The CHAIRMAN. If I could just make one comment on this nonbank bank argument, we spend so much time arguing about it and as all of you know I'm in favor of closing the nonbank bank loophole. It was part of my bill in 1984 and would have been law if the House had been willing to go to conference with us for nearly 2 years. So don't misunderstand me. But where the battleground is now and what you need to think about greatly has nothing to do with whether a nonbank bank loophole closure is eventually passed. It will be, not separately, but as part of some larger bill.

The real battleground is the grandfather date. Mine was July 1, 1983, but nearly 3 years have passed and that's where the big fight is going to be of how many that are in are going to try and get grandfathered. There are enough votes in the House and the Senate, in my opinion, to pass a loophole closure. The real battle is what the grandfather date is.

Senator GRAMM. Mr. Chairman, if it's already a foregone conclusion, maybe it's not worth using my question time.

The CHAIRMAN. Well, let's give them 1 minute each to respond and finish that one off and then we'll turn to you.

Mr. PETTY. I'll be brief. It's an issue in our mind of fairness and competitive inequality. Banks are denied a whole list of related products because of the way the banking laws and the regulators administer the phrase "closely related" to banking. We think it's too narrowly circumscribed and the Senate has entertained bills to broaden it and it's been favorably considered in this committee, I believe.

We think enacting H.R. 20 at this time would increase the imbalance to the disadvantage of the commercial banks and further create imbalance both geographically and by product line. Until we get an opportunity to have a broader range of products, and a broader range of geographic activities, we believe that the nonbank bank loophole should stay open. It can be closed in conjunction with the broadened powers of banks.

Senator RIEGLE. Mr. Malarkey.

Mr. MALARKEY. Yes. First, I would like to make clear nonbank banks are regulated as banks. In fact, I regulate three of the six we have in my home State. But banking law doesn't speak to many issues involved with nonbank banks because it was covered by the Bank Holding Company Act.

An example of that is mixing of commerce and banking, tied-in services, conflict of interest, interstate deposit taking, concentration of economic corporate power. Sears owns a bank in my State and all you've got to do is look at a Sears mailer to see what's involved.

Last, I do think, for instance, Chairman Gray of the Federal Home Loan Bank Board has been saying for a year that continued existence or the continued chartering of nonbank banks is going to make it extremely difficult to find buyers for troubled institutions.

The **CHAIRMAN**. Senator Gramm.

Senator **GRAMM**. Thank you, Mr. Chairman.

Mr. Malarkey, as I read your statement and listen to it, especially your statement that the Conference of State Bank Supervisors will never support measures to insulate the Federal Deposit Insurance Fund from assisting transactions or paying depositors it insures by selling interstate franchises, I assume that you're not opposing the bill currently before us but that you are opposed to the Garn-St Germain bill. Is that right?

Mr. **MALARKEY**. I don't believe that's quite correct, Senator. And I don't think we say we weren't willing to assist. We have said that there are some measures we would like included with the package that would make it more palatable to State supervisors.

Senator **GRAMM**. Well, I was just reading your statement. Let me go back and ask you a question. Do you or do you not support the Garn-St Germain bill?

Mr. **MALARKEY**. Yes, certainly we do.

Senator **GRAMM**. So your belief is that there is a significant difference between coming in and facilitating a transaction across State lines once a bank has gone broke and has defaulted versus having a set of priorities, a set of checks and balances, and trying to come in and provide for that transaction if there is no viable alternative within the State. You see that as a fundamental change related to a States rights issue?

FAULTS IN PRESENT BILL

Mr. **MALARKEY**. We do see it as a fundamental change, Senator. In the first place, who is going to set the definition of a failing bank? It isn't in here.

Second, there are 30 States, to the best of my knowledge, who have enacted some type of interstate legislation. Most of those bills include similar language as is in the regulators bill in some fashion. Oklahoma, who had a problem, just enacted a statute 1 week ago. And we feel that the States should have some option here to get in and make their own corrective action. We don't think that the regulators frankly have demonstrated this is a true emergency.

Senator **GRAMM**. So you believe that if the bank closes its doors and there is no in-State buyer, it's OK to cross State lines, but trying to do it before the bank goes broke represents a fundamental change in the status quo?

Mr. **Malarkey**. I don't say fundamental. I think in my testimony, Senator Gramm, I make clear that the CSBS stood ready to assist. All we ask for some amendments to the regulators bill.

Senator **Gramm**. Well, let me say that I would be happy to look at those amendments. I had many long visits with Mr. Sexton in my State. I have been very impressed by many of the ideas he has brought forward. We are working on those. I would be eager to look at any suggestions that you and the conference have.

Mr. **Malarkey**. We would be glad to give them to you.

Senator **Gramm**. I guess there's one point that bothers me in this whole discussion about States' rights. I have always considered myself to be a strong proponent of States' rights. A lot of my ancestors died for States' rights. But I think that a question that comes into focus here is, if the Federal Government or some agency of the Federal Government or composite of private interests, like the FDIC, is going to be holding the bag, at what point does the State and its regulations and its systems affect that?

For example, moving away from banking, we have great differences in State regulations of savings and loans. We have some States where we have savings and loans that are residual earners in the fried chicken business. We have other States where savings and loans are involved in traditional home mortgage lending, which is not as good as it used to be in terms of being safe, but it's still better than the fried chicken business in general in terms of risk.

Do you believe that perhaps we ought to have different premiums in FSLIC based on what the State laws are?

Mr. **Malarkey**. I would have to answer that as the commissioner from Delaware, Senator, because I not only regulate banks, I regulate S&L's. It's a little different from Commissioner Sexton. And I am not a proponent of risk-related assessments, but I think it's probably something we're going to have to come to.

If I'm going to use my institution and invest in fried chicken franchises as opposed to home mortgages, that's certainly a greater risk. We are dealing with an insurance and if I'm in a risky business, then I have to pay more insurance premium.

Senator **Gramm**. Well, let me say that I have come to that conclusion myself. Any realistic effort to deal with the problems of the FSLIC have got to deal with the great difference in the institutions we're regulating. We've got very old line, secure, conservative savings and loans that are paying the same insurance premium as companies that are heavy residual earners in very speculative investments.

Let me try one more on you and perhaps each of the members here testifying.

DIFFERENTIAL RATES

Let us say hypothetically that the ability to come in with out-of-State acquisitions in these emergency circumstances and since we've got Garn-St Germain as the law that exists everywhere preempting State law, but let's say that we could generate hard data that indicated that the ability to come in during a failing rather than after a failure, that created a more stable environment and the losses for FDIC were substantially lower in States that allowed that ability to FDIC than those that didn't.

Could you envision any circumstances under which the Conference of State Bank Supervisors might support differential FDIC rates?

Mr. MALARKEY. Differential FDIC rates?

Senator GRAMM. Lower rates for those that allowed the acquisition, higher for those that did not.

Mr. MALARKEY. Senator, that's not a question that the CSBS has addressed at this time, but I would be glad to have the CSBS respond to you in writing on that.

Senator GRAMM. Well, I'd be interested in it because I'm deeply concerned about whether we're going to have a national system that either is going to have to have differential rates or going to have similar practices. I think that as we have had States go in different directions in terms of regulation, in terms of practices, that to the degree that those things affect risk—and I'm not saying, Mr. Malarkey, that the data will ever show that there are these differentials, but I think that is the avenue where Federal involvement comes in. I'm concerned about the FDIC because it's not the Government's money. It's the money put up by bankers as part of doing business and I'm concerned about that money. I don't take the position that it's all right for them to come in and spend a lot of money to find an in-State solution when they could protect that fund in finding an out-of-State solution. I am not callous with regard to the use of that money.

I am hopeful that we can find a reasonable balance between the legitimate concerns that you express on behalf of the State regulators and the concerns of those of us who are worried about the FDIC, who are worried about a capital shortage in banking in a State like Texas that's created by the barriers that exist in terms of bank regulation, whereas under ordinary market circumstances if you have an exterior shock that destroys bank capital its value goes up, returns go up, and just like nature abhors a vacuum, competition abhors high profits, and they come in and compete them away.

I am concerned that unless we're careful here we're going to end up in one of two situations. No 1, if we continue to see bank capital destroyed in a State like Texas by the decline in oil prices, that we are either going to see a whole bunch of failures that will then allow us to bring the capital in, or we are going to see our system basically preserved, which is my guess as to what is going to happen. However, we're going to have a chronic bank shortage that could be alleviated and this adjustment period will be lengthened over what it could be if we could work out a reasonable compromise that satisfied States' rights, satisfied the State regulators, but at the same time, in a case where it's clear that a bank is failing, rather than waiting around and having FDIC take a bloodbath, rather than having a disruption of a local community or a whole State if you're talking about a big holding company, I'd rather come in and try to do something before that happens. I'm interested in preventing bank problems, not solving them. It seems that ought to be the role of Government in banking.

Finally, I see I have run out of time. Let me welcome Charles Doyle, one of my constituents, and a person I have a high regard for and whose opinions I value very highly to the committee. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, we have a vote and you have been saved by the vote from further questioning, but there are several of my colleagues, including myself, who will have some questions for your response in writing. And I think the Senator from Texas has made a very good point. Rather than polarizing on this issue, I would hope that we could have some suggestions that we could come to a compromise on.

Thank you very much. We appreciate your testimony.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

[Response to written questions of Senators D'Amato, Proxmire, and Riegle with additional material for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM THOMAS P. RIDEOUT

Q.1. Do you believe the dollar threshold in S.2372 should be eliminated for failing banks?

A.1. S.2372 reduces the dollar threshold for failing banks from $500 million to $250 million. While our Association supports this decrease it is not clear that lowering the threshold only to $250 million would provide adequate relief in the states that have large numbers of relatively small banks through interstate acquisitions. In order to ensure that the FDIC has adequate tools available to deal with failing banks in states that have no significant number of large banks, we would not object to an alternative provision that also provided for the acquisition of some number of the largest banks in the state, such as the ten largest banks.

Q.2. Do you believe that S.2372 should contain a provision that would give intrastate bidders for any failing bank a "headstart" in the bidding process?

A.2. We do not support giving intrastate bidders a "head start" in the bidding process in situations requiring swift action to resolve failing bank problems. As the same time, however, in order to preserve as far as possible state banking statutes governing interstate expansion, we would strongly support provisions giving intrastate bidders preference in the bidding process so long as all eligible bidders were given equal opportunity to submit their bids at the same time. For example, if an intrastate bidder is able to meet or exceed the bid of an out-of-state bidder, we would support a preference statute that would favor an in-state over an out-of-state solution. Moreover, we believe that any bid that would eliminate any need for FDIC assistance should be favored from an intrastate bidder over an out-of-state bidder, even where the out-of-state bidder is willing to pay a higher premium for a failing institution than an intrastate bidder.

Q.3. What reasons can you cite to support S.2372's limitations on an acquiring institution's expansion into only three standard metropolitan statistical areas?

A.3. S.2372's limitations on an acquiring institution's expansion into three standard metropolitan statistical areas is a compromise designed to balance the needs of the FDIC to make an acquisition attractive for prospective out-of-state bidders while, at the same time, preserving, as much as possible, a state's ability to maintain the integrity of its interstate banking restrictions.

Q.4. In testimony before the Committee offered on May 13, 1986, the federal bank regulators argued that this legislation was necessary. Do you believe that state and federal banking authorities currently lack the tools to address the problems confronting energy and farm banks thereby making passage of S.2372 imperative? Would full interstate banking provide a more workable solution to the problems confronting farm and energy lenders by allowing them to expand into economically sound regions rather than the stop-gap solution embodied in S.2372?

A. 4. Our Association supports S.2372 as a temporary addition to the tools available to Federal banking regulators to deal with failing and failed banks. At the same time, however, we do not believe that emergency legislation is the appropriate context in which to address interstate banking generally. We, therefore, support a three-year sunset provision being added to S.2372 which would ensure that after the immediate need for dealing with problem banks have been satisfied, this legislation would not become an end-run around interstate banking restriction.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM THOMAS P. RIDEOUT

Q.1. Can you explain in greater detail why you believe it is not appropriate for the regulators to use this bill in the case of a liquidity insolvency?

A.1. Our Association does not oppose the use of this bill in the case of a liquidity insolvency. Our concern is that the language in the bill is sufficiently broad to allow regulators to use the liquidity crisis, where a bank is not insolvent, to authorize an emergency interstate acquisition. A bank that is illiquid but not insolvent should be handled through access to the Federal Reserve Discount Window rather than through acquisition.

It is entirely possible for a bank that has perfectly solid assets to be temporarily short of the funds necessary to pay depositors and other creditors for their demands. In this situation, the Federal Reserve Discount Window has historically been available to provide an emergency source of funds for banks to meet demands for payment. So long as the value of the bank's assets continue to exceed the value of its liabilities, the bank would not be insolvent, and we believe that it would be inappropriate for bank regulators to be able to, in effect, extinguish the net ownership interest of bank shareholders through a forced sale of a bank solely because of liquidity problems.

Q.2. I notice the resolution passed by the ABA leadership conference emphasized strongly that legislation is also needed to close the non-bank bank loophole because the existence of the loophole undercuts the motivation to acquire failing banks.

I could not agree with you more and I applaud you for taking this position. Yesterday, Chairman Volcker and Mr. Seidman agreed with your position although they were not sure how much the non-bank bank loophole would undercut the purposes of the regulators' bill.

Can you fill in some of the details as to why you think it is important to close the non-bank bank loophole especially as it relates to the regulators' bill?

A.2. The existence of the nonbank-bank loophole threatens the ability of regulators to deal effectively with failing or failed banks. Where nonbank financial institutions have the ability to gain access to payment services through the purchase of a nonbank-bank, they have little or no incentive to assist in the rescue of failed financial institutions. By closing the nonbank loophole at the same time as the Regulators Bill is passed, the value of bank charters will be enhanced, and there will be additional bidders for failed banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM THOMAS P. RIDEOUT

Q.1. What significant cost savings, if any, do you see accruing to the FDIC as a result of the proposed expansion of the regulators' authority?

A.1. Our Association is not in the position to estimate the cost savings that may accrue to the FDIC as a result of the proposed expansion of emergency interstate acquisition authority included in S.2372. However, based on the experience of the FDIC with the current emergency interstate acquisition provisions of the Garn-St Germain Depository Institutions Act of 1982, it seems likely that the FDIC will be able to realize larger purchase premiums from the sale of failing or failed institutions through the interstate sale of these institutions, and may find out-of-state bidders in some circumstances where there are not intrastate bidders for certain failed or failing institutions.

Q.2. I would like to get the reaction of the panel to the suggestion that any emergency acquisition under the expanded authority should be permitted only if the state banking regulator in the failing institution's home state does not object to the acquisition.

A.2. Our Association supports a strong role for the state banking supervisors in the interstate acquisition process. While we would not support giving an absolute veto to state banking supervisors, we would support provisions requiring unanimous votes or super majorities by Federal regulators to approve interstate acquisitions over the objection of the state regulators. In addition, we believe that wherever an in-state bidder submits a bid high enough to eliminate the need for any FDIC assistance in the acquisition of a failed or failing institution, an out-of-state bidder should not be allowed to match or exceed that bid.

Q.3. A number of you have criticized the regulators' bill for using imprecise and imperfect criteria to establish what is and what is not a bank "in danger of closing". What recommendations do any of you have for a more precise definition?

A.3. In defining a bank "in danger of closing", our Association believes that the key criteria could be the market insolvency of the institution. Suggestions, such as those embodied in S.2372, that a liquidity crisis would make a bank "in danger of failing" ignores the availability of the Federal Reserve Discount Window to provide short-term liquidity funding for institutions that are solvent but experiencing temporary liquidity problems. The use of a market insolvency criteria - that is, when the market value of an institution's assets are equal to or less than the market value of the institution's' liabilities - would ensure that bank shareholders would not be denied the continuing value of their ownership interest in a depository institution in the absence of a market insolvency of that institution.

Q.4. To what extent, if any, do you believe that some form of preferential treatment should be given to an intrastate or intra-region bank?

A.4. As explained in Question 2 above, our Association believes that geographic provisions in state and Federal bank statutes could be preserved as far as possible in dealing with emergency interstate acquisitions. We, therefore, believe that, so long as an in-state bidder is able to relieve the FDIC of any financial liability in a failing or failed institution, there should be not preference to out-of-state bidders. Moreover, we also believe state banking supervisors should be fully involved in the process of determining whether out-of-state bids are necessary to find a purchaser for a failed or failing institution.

Q.5. To what extent do you believe it might be counterproductive to signal the demise of a bank by formally classifying it as failing and openly seeking bidders, as might be the case under the regulators' bill?

A.5. It is our understanding that the Regulators Bill is not designed to seek bidders under the failing bank provisions on open bid. Today, regulators frequently seek bids on failed institutions before they are closed without, in most circumstances, notifying depositors. We would anticipate that this process would be continued under this bill and that there would be no public announcements of a bank's classified status.

Q.6. In the past, the bank regulatory agencies have been able to handle a number of bank problems and failures without the need for the type of legislation we are considering today. A number of instances come readily to mind: Franklin National Bank and the U.S. National Bank; the First Pennsylvania Bank; and Continental Illinois to name a few.

Do you believe that the same imaginative remedies that were used in those instances could be used in future instances without additional legislation?

A.6. Although it is true that bank regulatory agencies have been able to handle the failures of large institutions in the past without resorting to the out-of-state bidding, several factors have arisen that support the provisions of S.2372. First, it is anomalous to cite the Franklin National Bank where foreign bidders were given preference in buying domestic American banks over domestic American banking companies. Second, most of the instances of failures cited came during a period when there were far fewer bank failures that the regulators had to handle in any given year than there are currently. The increased number of failing institutions makes it more difficult to find bidders because failing banks no longer have the "scarcity value" that they had during other periods in the history of the FDIC. Moreover, as the Continental Illinois situation demonstrates, alternatives to interstate acquisition can involve unintended side effects such as the bail out of creditors and holding companies that occurred in the Continental situation.

Q.7. In the past when we have had actual, as opposed to potential banking crises, states have acted expeditiously to address the situation. Given the fact that states have the capacity and the responsibility to act when necessary, what do you see as the compelling reason for federal involvement and preemption at this time?

A.7. State legislators have consistently shown a willingness and ability to act quickly in times of financial crises. However, some of the laws that have been passed may be insufficiently clear or more costly and time consuming than is appropriate in dealing with emergency situations. If uniform statutes can be developed that would provide consistency of treatment and ease of application for failing banks, we would agree that there would be no need for emergency legislation such as S.2372. At this time, however, such statutes have not been passed, other than in a few states, and the large number of bank failures that the industry is currently experiencing supports the need for this type of emergency legislation.

Q.8. Why isn't the interest of a state in fashioning a timely and suitable remedy to a problem situation at least as great as that of the FDIC, if not more so?

A.8. The interest of many states in fashioning timely and suitable remedies to problem situations may often be as great as that of the FDIC. Nevertheless, it is often true that because states do not have the same financial interest in failing institutions as does the FDIC, a state may not be motivated to act as quickly or with as much clarity in its statutes as might be necessary.

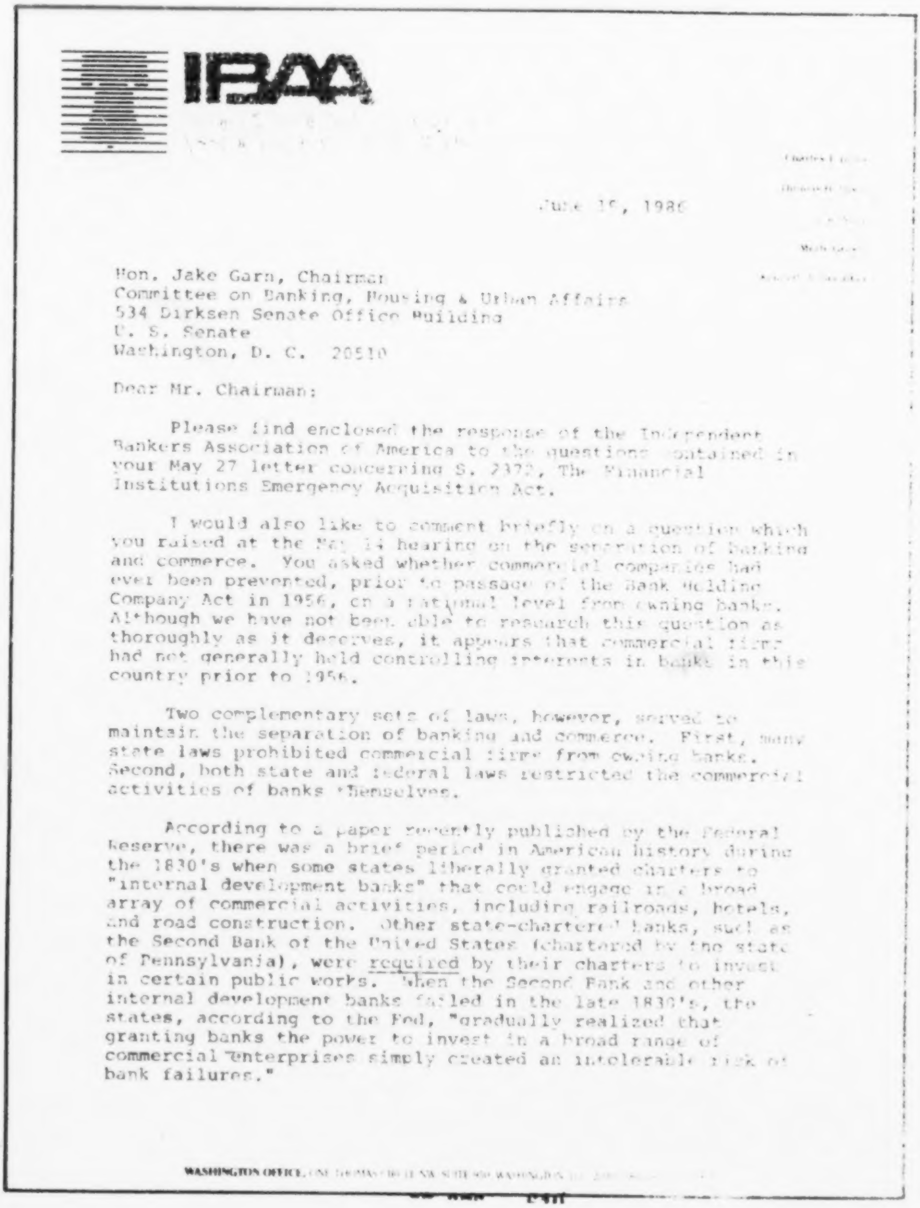
Q.9. How would each of you propose dealing with the stockholders of a bank that is merged with federal assistance because it is "in danger of closing"?

A.9. The stockholders of a bank that is merged because of being "in danger of closing" could be entitled to an individual pro rate refund after the problem assets had been liquidated. While each individual merger would need to be analyzed on its own merits, there may be circumstances in which the net worth left over after problem assets have been disposed of was sufficient to provide some return to shareholders.

Q.10. The regulators' proposed bill, as I understand it, would permit the sale of an entire holding company if a certain percentage of its assets are in the failing category. I would think, however, that there would be a certain attraction to selling only those subsidiaries considered failing, along perhaps with other subsidiaries with capital deficiencies that have arisen in a normal course. I would like to get your reaction to the regulators' proposal which would allow the sale of the entire holding company?

4
RIEGLE--RIDEOUT

A.10. There are two principle reasons when an entire holding company is sold for a significant proportion of the subsidiary bank assets to determine the entire holding company's fate. From a bidder's standpoint, it is far more attractive to bid on a holding company as an entity because it is far easier to value the consolidated assets and liabilities of the entire holding company. In addition, the prospect of requiring entry into all of the markets of the holding company banks will be more attractive to potential bidders than the loss of those markets that are supporting the higher percentage of earnings assets of the holding company. From a regulator's perspective, the sale of an entire holding company will avoid potential problems to other holding company subsidiaries that may otherwise get out of the bidding process without financial support from the parent holding company.



IBAA

June 15, 1986

Hon. Jake Garn, Chairman
Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Office Building
U. S. Senate
Washington, D. C. 20510

Dear Mr. Chairman:

Please find enclosed the response of the Independent Bankers Association of America to the questions contained in your May 27 letter concerning S. 2372, The Financial Institutions Emergency Acquisition Act.

I would also like to comment briefly on a question which you raised at the May 14 hearing on the separation of banking and commerce. You asked whether commercial companies had ever been prevented, prior to passage of the Bank Holding Company Act in 1956, on a national level from owning banks. Although we have not been able to research this question as thoroughly as it deserves, it appears that commercial firms had not generally held controlling interests in banks in this country prior to 1956.

Two complementary sets of laws, however, served to maintain the separation of banking and commerce. First, many state laws prohibited commercial firms from owning banks. Second, both state and federal laws restricted the commercial activities of banks themselves.

According to a paper recently published by the Federal Reserve, there was a brief period in American history during the 1830's when some states liberally granted charters to "internal development banks" that could engage in a broad array of commercial activities, including railroads, hotels, and road construction. Other state-chartered banks, such as the Second Bank of the United States (chartered by the state of Pennsylvania), were required by their charters to invest in certain public works. When the Second Bank and other internal development banks failed in the late 1830's, the states, according to the Fed, "gradually realized that granting banks the power to invest in a broad range of commercial enterprises simply created an intolerable risk of bank failures."

WASHINGTON OFFICE, [illegible]

I have enclosed a copy of this Federal Reserve paper for your review. It shows that the separation of banking and commerce has deep roots in Anglo-American history and has periodically been reinforced by economic catastrophes such as those suffered in the Panic of 1937 and the Great Depression. The IBAA hopes that the Committee will consider these historical reasons for the separation of banking and commerce when it takes up legislation in the near future to close the nonbank bank and the nonthrift thrift loopholes.

Sincerely,

Charles T. Doyle

Charles T. Doyle
President

CTD/gk

Enclosures

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
CHARLES T. DOYLE

Q.1. Do you believe the dollar threshold in S.2372 should be eliminated for failing banks?

Response: The IBAA strongly urges that the dollar threshold in S.2372 be raised, not lowered, from $250 million, to $500 million, with an exception for the four largest banks in each state if they are smaller than $500 million. This would give the FDIC additional flexibility without unduly preempting state laws that restrict interstate acquisitions.

Q.2. Do you believe that S.2372 should contain a provision that would give intrastate bidders for any failing bank a "headstart" in the bidding process?

Response: Yes, there should be a bidding preference for in-state banks. One possibility would be to add a provision to S.2372 requiring the FDIC to give a preference to the highest in-state bid if it would result in less cost to the FDIC than a payoff of insured depositors.

Such an amendment would ensure a meaningful incentive for in-state banks to submit bids on failed and failing banks. Under the 15% differential contained in Title I of Garn-St Germain, an in-state bid has to come within 15% or $15 million, whichever is less, of the highest out-of-state bid in order to qualify for the right to re-bid. This provision would not provide an adequate in-state preference under S. 2372.

Q.3 What reasons can you cite to support S.2372's limitations on an acquiring institution's expansion into only three standard metropolitan statistical areas?

Response: The IBAA does not support federal legislation dictating the intrastate expansion rights of an out-of-state acquirer. This has always been a matter of state law and should continue to be.

It is important to note that states are likely to react differently to the prospect of out-of-state emergency acquisitions, depending upon the particular situation. In some cases, a state may be more liberal in granting expansion rights to out-of-state acquirers than the 3 metropolitan areas included in the bill.

Q.4 In testimony before the Committee offered on May 13, 1986, the federal bank regulators argued that this legislation was necessary. Do you believe that state and federal banking authorities currently lack the tools to address the problems confronting energy and farm banks thereby making passage of S.2372 imperative? Would full interstate banking provide a more workable solution to the problems confronting farm and energy lenders by allowing them to expand into economically sound regions rather than the stop-gap solution embodied in S.2372?

Response: The IBAA is not at all convinced that legislation as broad as S.2372 is needed to deal with current problems in agricultural and energy banks. In fact, the new capital forbearance program initiated by the regulators in late March 1986, which was designed to assist banks whose capital has been severely impaired, has gotten off to a slow start, suggesting that the regulators have powerful tools at their disposal which have not yet been fully utilized. Full interstate banking, on the other hand, would do nothing to help these problem banks because they would not be in a position to expand into "economically sound regions" nor would they make appealing acquisition targets under nationwide banking.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM CHARLES T. DOYLE

Q.1. In addition to being a spokesperson for the IBAA, you are also a banker from Texas. What is your perception of the banking situation there? Are we on the brink of a banking emergency that requires immediate action by the United States Congress?

Response: I personally think that the situation in Texas, while serious, is not one which cannot be handled by the marketplace and the State of Texas, in conjunction with the FDIC. Bankers are well aware of the crisis in oil and gas and have drastically changed their ways of doing business over the last 12 months. There is some evidence of overreaction by examiners representing the various regulators, resulting in very substantial loan reserves to match the conservative classification of bank loans. This gives the appearance of the situation being a lot worse than it really is since many of these classifications are subjective judgments. Also, we shouldn't forget that there are a lot of banks in Texas that are doing quite well and are in a good position to expand into new services and markets.

Q.2. Yesterday, Chairman Seidman repeatedly raised an equity argument in attempting to justify this bill. He said it was not fair to most of the banks to pay premiums into the FDIC fund and then have the fund incur higher expenses because a state does not permit out-of-state bank acquisitions.

I have yet to meet a single banker who is troubled by this alleged inequity but perhaps there are some. You represent over 11,000 banks. Are any of your members losing sleep over the inequities outlined by Chairman Seidman?

Response: Our members care about more than just the level of their FDIC assessments. Bankers in New York do not generally complain because of unit banking laws in Texas or laws prohibiting interstate acquisitions in Iowa. They realize that there are many structural and economic differences among the 50 states that may result in more bank failures in particular states and that failures normally result from either poor management or a poor economy or both--not from a state's structure. On balance, they realize that it is in each state's and each bank's interest to prevent large numbers of bank failures within a state.

Q.3. If Chairman Seidman is really troubled about the inequitable distribution of FDIC premiums, can you think of any way the existing system can be made more equitable?

Response: There are inequities in the present system which need to be corrected. There is much concern over the inequity of domestic depository banks being overcharged assessments to protect foreign deposits in U.S. banks. These foreign deposits are not included in the FDIC assessment of the big banks. In addition, 75% of the uninsured deposits over $100,000 are in our nation's largest banks that are "too big to fail," and as a result receive de facto FDIC insurance coverage. We feel this is the type of inequity the FDIC should be concerned about rather than the structural question.

3
PROXMIRE--DOYLE

Governor Nigh Signs Branching Law Liberalizing Purchase of Failures

OKLAHOMA Governor George Nigh signed a bill last month that permits Oklahoma banks to purchase failed banks anywhere in the state and convert them into branches.

The new law also permits healthy banks to acquire, but not establish, branches as far away as 50 miles from the head office as well as to acquire four healthy branches instead of the two formerly permitted.

Both the Oklahoma Bankers Association and the Community Bankers Association of Oklahoma supported the law, but it took some time for the two associations to see eye to eye on the issue.

However, once differences were ironed out, the state's bankers gave solid support to the emergency provision in the law because it means it will be possible to obtain more bidders for failed banks. Legislators said the provision would give bidders more incentive to purchase failed banks because less capital is required to acquire or open a branch than to open a new bank.

In the recent past, according to James P. McKeown, executive manager, Community Bankers Association, many failed banks couldn't be purchased by other capital-rich institutions because they were located outside the then 35-mile radius for consideration as an acquiring institution.

The new law cancels a special provision that enabled banks in Oklahoma County to establish a branch within five miles of its headquarters regardless of whether the branch was outside city limits.

The law also broadens the scope of the 1983 provision that prohibited total deposits of bank HCs in the state from exceeding 11% of the combined deposits of the states' financial institutions. As it now stands, the provision applies to all banks, HC owned or not.

It's too soon to determine if banks will be taking advantage of the law's provisions, according to Mr. McKeown. It would seem logical, he says, for small chains to consolidate to improve their capital positions.

The Community Bankers Association was instrumental in wording the new law so that failing banks as well as failed banks are covered by the provision permitting acquisitions. However, it hasn't yet been determined how a failing bank will be defined by the banking commissioner's office.

"We believe the new law is absolutely favorable to community banks because they have adequate capital to participate in acquisition programs," Mr. McKeown says. Community banks wanted to have the tools available to facilitate mergers involving problem banks. ● ●

A Credit Card for Your Car? Sure! Says First of Wichita

IT MAKES sense for your car to have its own credit card, say the people at First National, Wichita. Why? Because many people need to keep track of auto expenses for tax-reporting purposes!

So the First Bank Card Center, a division of the bank, has developed the Auto Care Credit Card.

"Based on what First Bank Card Center was experiencing with current VISA and MasterCard use, we saw a need for people to maintain a separate line of credit just for car expenses," said Laura Connor, assistant vice president. "The advantage of a separate credit card just for your car is that it provides an excellent way to keep track of car repairs and maintenance, whether for family budgeting or for business and tax purposes."

A two-year test run in Wichita has been declared a success, so now the card is available in Manhattan, Emporia, Augusta, Salina and Wellington. Approximately 50 auto dealerships, tire and auto parts stores and alignment, body, tune-up and muffler shops accept the card.

"Merchants seem to like it," said Ms. Connor. "They find it just as convenient as MasterCard and VISA and it cuts down on their having to carry receivables."

Cardholders have access to special checks that can be written against their Auto Care Card accounts for auto insurance, vehicle tags and taxes. ● ●

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM CHARLES T. DOYLE

Q.1. What significant cost savings, if any, do you see accruing to the FDIC as a result of the proposed expansion of the regulators' authority?

Response: In the short term, the FDIC may realize some cost savings by selling banks interstate in situations where the only alternatives are that they be sold in-state at a lower premium or be liquidated. However, these savings would have to be offset against the higher long-term costs of weakening state control over banking, increased concentration of banking services in the hands of a few nationwide banks, and the costs of assisting these very large banks when they fail.

Q.2. I would like to get the reaction of the panel to the suggestion that any emergency acquisition under the expanded authority should be permitted only if the state banking regulator in the failing institution's home state does not object to the acquisition.

Response: The IBAA supports the concept of a state regulators' veto over interstate emergency acquisitions. This is needed in order to protect the integrity of state law and the Douglas Amendment. Our dual banking system can survive only if state regulators are allowed the greatest possible control over banking structure and chartering authority in their respective states.

Q.3. A number of you have criticized the regulators' bill for using imprecise and imperfect criteria to establish what is and what is not a bank "in danger of closing." What recommendations do any of you have for a more precise definition?

Response: The term "in danger of closing" should be more strictly defined by 1) providing that a failing bank's total capital must have been reduced to "proper and adequate loan valuation reserves" (i.e. loan loss reserves), and 2) adding a requirement that the shareholders must agree to forego any proceeds from the sale or transfer of their shares to an out-of-state acquirer. These amendments are designed to ensure that there be some objective standard for what constitutes a failing bank and that shareholders would not receive a windfall from the out-of-state sale of a failing bank.

Q.4. To what extent, if any, do you believe that some form of preferential treatment should be given to an intrastate or intraregion bank?

Response: See response to D'Amato question number 2.

Q.5. To what extent do you believe it might be counterproductive to signal the demise of a bank by formally classifying it as failing and openly seeking bidders, as might be the case under the regulators' bill?

Response: There is a real danger that if troubled banks were publicly identified as "failing," it could cause a run or otherwise make it more difficult to sell the bank to another institution. This is one reason the IBAA has preferred the FDIC's proposal for additional authority to establish conservatorships or "bridge banks," which would allow the FDIC to infuse capital and new management into the bank until a purchase and assumption could be arranged.

Q.6. In the past, the bank regulatory agencies have been able to handle a number of bank problems and failures without the need for the type of legislation we are considering today. A number of instances come readily to mind: Franklin National Bank and the U.S. National Bank; the First Pennsylvania Bank; and Continental Illinois to name a few.

Do you believe that the same imaginative remedies that were used in those instances could be used in future instances without additional legislation?

Response: Yes. In particular, the Garn-St Germain Act of 1982 gives the FDIC broad authority to provide assistance to open (i.e. "failing") institutions. The agency can make loans to, make deposits in, purchase the assets or securities of, or assume the liabilities of, an open bank in emergency situations. The authority and flexibility already exist to deal with virtually any situation, but it may be more costly or cumbersome than a quick interstate sale. However, other policy considerations other than cost must be considered.

Q.7. In the past when we have had actual, as opposed to potential, banking crises, states have acted expeditiously to address the situation. Given the fact that states have the capacity and the responsibility to act when necessary, what do you see as the compelling reason for federal involvement and preemption at this time?

Response: We do not see any compelling reasons justifying expanded federal authority at this time. The attached news account from the Mid-Continent Banker describes how Oklahoma, for example, has recently enacted legislation aimed at dealing with emergency out-of-state acquisitions. Such state initiatives are generally the best way to deal with what are often local economic problems.

Q.8. Why isn't the interest of a state in fashioning a timely and suitable remedy to a problem situation at least as great as that of the FDIC, if not more so?

Response: A state's interest is often as great, if not greater, than the FDIC's in fashioning a prompt and effective remedy. A large- or medium-sized bank failure in a state is likely to have a ripple effect on many other banks within the state, since correspondent bank and loan participation relationships tie many banks within a state together. This means that the adverse economic effects of a bank failure are likely to be concentrated in the home state of the failed bank. The failure of United America Bank (Knoxville, Tenn.) and other banks in the Butcher chain is a classic example of how this ripple effect can be particularly devastating to the economy of a single state.

Q.9. How would each of you propose dealing with the stockholders of a bank that is merged with federal assistance because it is "in danger of closing?"

Response: See response to question 3 above.

Q.10. The regulators' proposed bill, as I understand it, would permit the sale of an entire holding company if a certain percentage of its assets are in the failing category. I would think, however, that there would be a certain attraction to selling only those subsidiaries considered failing, along perhaps with other subsidiaries with capital deficiencies that have arisen in a normal course. I would like to get your reaction to the regulators' proposal which would allow the sale of the entire holding company?

Response: The IBAA is opposed to any provision which would permit the interstate sale of an entire bank holding company. In the past, the regulators have been able to sell off individual banks that have failed in a holding company or to require the holding company to sell off good assets or individual banks to raise capital for the holding company. In Continental Illinois, the FDIC took an equity position in the failing holding company until it could be restored to health. All these options are currently available to the FDIC to deal with holding companies on a case-by-case basis.

The Separation of Banking and Commerce In American Banking History

It has been asserted that there is no traditon of separating banking and commerce in the United States. Based on a review of historical treatises, articles, state and federal statutory materials, legislative histories, court decisions, bank charters, and other materials enumerated in the bibliography, this paper concludes that the separation of banking and commerce has been a prevailing principle applied to commercial banks in America since colonial times.

I. 18th Century Banking

Commercial banks developed in colonial times to fill the need for money as a medium of exchange and as a source of liquid capital.[1] Bank activities generally were limited to issuing currency, accepting deposits, and making loans to business and government. Because the money creating function of banks affected the larger economic welfare, banks were regarded as quasi-public institutions and were subject at an early date to an unusual degree of government supervision and regulation.[2]

The early American concept of banking was influenced by the "real bills" doctrine enunciated by Adam Smith in *The Wealth of Nations* published in 1776. Smith wrote that the proper function of a bank was limited to making short-term, self-liquidating loans to finance the conversion of raw materials into goods and move them to market.[3] This doctrine was necessitated by the demand nature of bank funds. A bank could not meet its obligation to pay its liabilities on demand if its assets were tied up in long-term, illiquid assets. Early bank charters typically limited the duration of loans to 30 days, 45 days, or generally no more than three months, with some states restricting loan renewals.[4]

The real bills doctrine had as its primary objective the stabilization of the banking system. In the 18th and 19th Centuries, there was no federal safety net and banks had to remain liquid, solvent, and profitable on their own. The real bills doctrine was accepted as the "best rule of thumb" for banks to follow.[5]

The separation of banking and commerce was a necessary corollary of the real bills doctrine. Under the orthodox view, the assets of a commercial bank had to be capable of ready liquidation. Bank investments in real estate and corporate stock or other enterprises were inconsistent with this view.[6]

Early state and federal bank charters were patterned after the charter granted by Parliament to the Bank of England in 1694. The Bank of England was prohibited from "directly or indirectly dealing or trading or permitting anyone on their behalf to deal or trade, with any of the money, stock or effects of the corporation, in buying or selling any goods, wares or merchandise whatsoever."[7] Treble damages were imposed for violations of this stricture. This charter restriction was deemed necessary to avoid "the hazard of bankruptcy" as well as to allay fears of merchants that the bank's powers would give it an unfair competitive advantage and monopoly control.[8]

The Bank of North America

The first incorporated bank in the United States established the principle of banks as a type of public utility operating in close relation to government needs and the public interest with limited powers that separated them from commerial enterprises. The Bank of North America, chartered by the Continental Congress in 1781 to help finance the Revolutionary War and reincorporated by Pennsylvania in 1786, was limited to issuing demand notes, accepting deposits, making short-term loans, and acting as fiscal agent of the federal government. Echoing the Bank of England's charter, the bank was specifically prohibited from trading in merchandise and from owning real estate except as necessary for its place of business and for loan collateral. These provisions, and a 14-year limit on the bank's charter, were intended to keep the bank "closely within the reach of the state."[9]

First Bank of the United States

Alexander Hamilton's "Treasury Report on a National Bank" in 1790 reflected the concept of banking as limited to providing a means of exchange and making

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short-term loans for business purposes and clearly did not contemplate the bank's involvement in commercial enterprises.[10] The 1791 Act establishing the First Bank of the United States on the basis of Hamilton's Report was modeled after the Bank of England and specifically provided that the bank could not "directly or indirectly deal or trade in any thing, except bills of exchange, gold or silver bullion, or in the sale of goods really and truly pledged for money lent and not redeemed in due time; or of goods which shall be the produce of its lands."[11] The bank's powers to invest in real estate were limited to that "as shall be requisite for its immediate accommodation in relation to the convenient transacting of its business and such as shall have been bona fide mortgaged to it by way of securities, or conveyed to it in satisfaction of debts previously contracted in the course of its dealings."[12]

A description of the First Bank's activities in the Report of the Secretary of the Treasury in 1809 indicated that the bank was not engaged in any activities other than narrowly circumscribed banking activities. The Report depicted the Bank as engaged strictly in the acceptance of deposits, the issuance of bank notes and credits as a circulating medium, the payment of drafts drawn on the bank by individuals, and the payment of dividends to shareholders. The property of the Bank consisted of "1st, outstanding debts, consisting principally of notes payable at sixty days, which have been discounted at the bank; 2dly, specie in the vaults; 3dly, buildings necessary for the institution."[13]

II. 19th Century Banking

By 1800, 29 commercial banks were operating in the United States, mainly on the Hamiltonian model.[14] As the banking system developed in the 19th Century, the concept of banking as limited to issuing currency, accepting deposits, and making loans continued.

Because of the recognized importance of banking to the larger economic welfare and the need to ensure the safety of deposits, regulation of banks came to be one of the essential functions of government.[15] Banking generally was not permitted without express government authorization and had to be conducted in an incorporated entity.[16] Early restraining acts typically prohibited unincorporated entities from issuing notes or otherwise engaging in banking activities. Later laws prohibited corporations from exercising banking powers unless expressly authorized to do so. By 1830, almost all of the states had confined the right to engage in banking to incorporated banks.[17] Nearly all of the states required banks to organize either under special acts or under a general banking law that differed materially from the general business incorporation law.[18]

By the end of the first quarter of the 19th Century, the notion that banks should be separated from commercial ventures was well established. Willis and Bogen state that "[t]he primitive condition of the country, the preponderant importance of trade, and the requirements of state laws caused these banks to restrict their activities almost entirely to purely commercial banking transactions."[19]

The charter of the Second Bank of the United States in 1816 included provisions similar to those of the First Bank limiting its involvement in nonbanking activities.[20] State chartering laws also included similar prohibitions. Typical of the state statutes was the Pennsylvania Act of 1814 which chartered 41 banks with identical charters. The banks were prohibited from dealing or trading in any manner in merchandise or stock, except for bank stock, government securities, bills of exchange, and gold or silver bullion.[21] New York banks in 1825 were authorized to "carry on the business of banking by discounting bills, notes, and other evidences of debt; by receiving deposits; by buying gold and silver bullion and foreign coins; by buying and selling bills of exchange, and by issuing bills, notes, and other evidences of debt" and were to have "no other powers whatever."[22]

Internal Improvement Banks

The separation of banking and commerce was not strictly adhered to in the second quarter of the 19th Century. Industrialization and the opening of the south and west generated vast capital needs to support the nation's rapid internal growth. The states began to freely grant bank charters to fill this need. Charters were granted to any group of individuals who had the necessary capital and met other minimum qualifications.

This period, known as the "free" or "wildcat" banking era, saw widespread speculation throughout the country, particularly in the frontier states. Numerous banks sprang up "willing to finance almost any conceivable proposal."[23] It was not uncommon for the "less financially orthodox" states to charter internal improvement companies to build canals, railroads, hotels, and turnpikes with powers to issue notes in order to raise capital or to require banks to invest in the stocks of various public works projects.[24]

The experience of these ventures tended to encourage the view that banking could not be safely commingled with nonbanking activities. The assets of the internal improvement banks were devoid not only of liquidity but frequently of value. When a business venture failed, as many of them did in the Panic of 1837, so much of the bank's assets were lost that the bank could not redeem its notes and function as a bank.[25]

Although the internal improvement banks no doubt helped to finance and construct a number of valuable public works projects, these companies were so insecure as banks that historians have described their operations as "building America through bankruptcy," "disastrous," and a "nightmare."[26] The National Monetary Commission, in assessing the combination of railroads and banking in Mississippi, concluded that

> Mississippi was gridironed with imaginary railroads and beridden with railroad banks. In these enterprises there was more watered stock sold than there were cross-ties laid; reckless speculation brooked nothing as prosaic as the actual construction of railroads, on the successful operations of which it was supposed fabulous dividends would be declared.[27]

In 1836, Pennsylvania rechartered the Second Bank of the United States as a state bank with a directive that the bank invest in public works projects. Symons reports that "[t]here was hardly a commercial enterprise in the United States in which this bank did not either directly or indirectly invest."[28] When the value of the bank's investments declined, the bank failed spectacularly, losing $35 million in capital. The Pennsylvania bank was the last 19th Century bank of its kind as "state governments gradually realized that granting banks the power to invest in a broad range of commercial enterprises simply created an intolerable risk of bank failures."[29]

Development of State Banks

The six years following the Panic of 1837 saw approximately one fourth of the total number of banks fail.[30] This experience encouraged states to limit the involvement of banks in nontraditional activities:

> The experience of the wildcat banks resulted in a general disposition to curtail banking activity, and especially to demarcate commercial and investment banking. In the southern states, for example, where some of the worst examples of unsound banking had occurred, amendments were generally passed severely restricting investments by banks in real estate and securities. There was a general disposition to recognize the essential differences between banking with liquid and illiquid assets, and doubtless the experience of the panic period played an important role in making relatively complete the segregation of commercial and investment banking institutions in this country.[31]

Bank powers again were confined to issuing notes, accepting deposits, and making loans. With the exception of issuing notes, which were taxed into retirement by the National Currency Act of 1863, the powers of state banks remained thus limited throughout the remainder of the 19th Century and into the 20th Century.[32]

It was not uncommon for state banks to be chartered to serve special economic groups. In 1860, there were more than 60 banks for farmers, 50 for mechanics, 45 for merchants, 20 for traders, 15 for manufacturers, and various banks for lumbermen, grocers, importers, miners, wheat growers, reapers, millers, and whalers.[33] The banks financed these businesses through loans or the purchase of bonds, but did not engage in the business of the borrowers.

Private Banks, Savings Banks, and Trust Companies

State institutions that combined banking powers with broader activities developed outside of the commercial banking structure in the post-Civil War period.[34]

Private banks were unincorporated banks that accepted deposits but, unlike commercial banks, were free to pursue any activity because they did not issue notes as a form of currency.[35] Most of the private banks were small institutions that opened in localities that could not support a bank with the minimum capital required by law and confined their activities to normal banking operations. Although they were referred to as banks, many states prohibited them from using the name "bank".[36]

A small but significant number of private banks, particularly in the larger cities, combined banking activities with mercantile, real estate, and securities investment, brokerage, and underwriting operations.[37] These private bankers generally accepted deposits only from their corporate clients, friends, and employees, and rarely from the general public, and dealt in bankers' acceptances, commercial paper, letters of credit, and foreign exchange. Among their ranks were names such as J.P. Morgan & Co., Kuhn, Loeb & Co., Goldman, Sachs, J. & W. Seligman, Lehman Brothers, Kidder, Peabody, and Brown Brothers & Co. These private banks became the investment bankers that dominated the investment banking business in the early 20th Century. Their deposit taking activities were terminated with enactment of the Glass-Steagall Act in 1933.[38]

Savings banks also developed in the 19th Century, primarily as home lenders in the New England states. These banks accepted savings deposits but, unlike commercial banks, generally did not accept demand deposits or make commercial loans. Their activities were less restricted than commercial banks, and some of these banks made significant stock investments in nonbanking companies. A spate of savings bank failures following the panic of 1873 led to more conservative practices, however. In addition, the mutual form of many savings banks limited the opportunities for private gain. These banks thus did not significantly depart from the separation of banking and commerce principle.[39]

Trust companies expanded their business beyond fiduciary activities in the latter part of the 19th Century. It was not uncommon for commercial banks to organize as trust companies in order to acquire trust powers otherwise denied to them as well as to take advantage of less restrictive regulation.[40] Trust companies frequently were organized under the general business law rather than the banking law and were free to accept deposits and engage in any business activity, although most confined their activities to the banking and trust business.[41]

By the early 20th Century, a significant number of trust companies were active in the securities business. Many of them became affiliated with large investment houses or, like the large private banks, became investment bankers themselves. Trust company affiliates provided a vehicle for commercial banks and life insurance companies to engage indirectly in securities activities prohibited to them. The securities activities of these companies eventually were prohibited in the Glass-Steagall Act in 1933.[42]

III. The National Banking System

The policy of separating banking and commerce was embodied in the national banking system established in 1864. The National Bank Act of 1864 reflected the limited concept of banking that confined banks to issuing currency, accepting deposits, and making short-term commercial loans. National banks were limited to exercising

> all such incidental powers as shall be necessary to carry on the business of banking by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; by obtaining, issuing, and circulating notes according to the provisions of this act. . . .[43]

This language has remained in the National Bank Act essentially unchanged since its original enactment.

The courts interpreted the National Bank Act strictly to allow national banks to exercise only those powers expressly conferred or those incidental to their express powers.[44] The scope of national bank powers was tested in several early cases involving attempts by national banks to engage in broad commercial activities. Generally, the courts refused to allow national banks to place depositors' funds at risk by engaging in unauthorized nonbanking activities and allowed the banks to raise the defense of *ultra vires* in order to escape liability for their involvement in unauthorized activities.

In *First National Bank v. Converse*, 200 U.S. 425 (1906), a national bank participated with creditors of a failed manufacturing company in organizing a new corporation to assume the business of the failed company. The U.S. Supreme Court ruled that a national bank had no power to engage in or promote a purely speculative business.

In *Gress v. Village of Ft. Loramie*, 125 N.E. 112 (Ohio 1919), the court ruled that it would be *ultra vires* for a bank to operate a railway. In *Cooper v. Hill*, 94 F. 582 (Col. 1899), it was held *ultra vires* for a national bank to carry on an ordinary mining, manufacturing, or trading business, or a speculative venture such as prospecting for ore. Similarly, in *First National Bank v. Stokes*, 203 S.W. 1026 (Ark. 1918), it was held *ultra vires* for a national bank to engage in buying and selling cattle.

Like state banks, national banks were expressly prohibited from owning real estate except for bank premises and real estate acquired through foreclosures and debts previously contracted.[45] Unlike state banks, which could make real estate loans subject to certain restrictions, national banks were barred from making loans secured by real estate.[46] The purpose of the restrictions on national bank real estate powers was stated to be

> threefold: . . . to keep the capital of the banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in their hands, to be held, as it were in mortmain.[47]

National banks were not authorized to engage in securities activities other than investment in federal and state government securities, although they could make call loans repayable on demand with stock as collateral.[48] In this regard, the national banking system followed the traditional English concept:

> In its early history, the American banking system, at least in theory, held to the traditional English view—*i.e.*, that banks which accepted deposits from the public should not engage in investment banking. During the latter half of the 19th Century, the national banking system generally followed, albeit imperfectly, the English practice of separating commercial and investment banking functions.[49]

A divergence from a strict separation began when the courts interpreted the clause "by discounting and negotiating promissory notes . . . and other evidences of debt'' in the National Bank Act to give national banks implied power to invest in state, municipal, and corporate bonds.[50] Once national banks could invest in municipal and corporate securities, it was difficult to distinguish underwriting and the Comptroller allowed the banks to underwrite bonds to the extent they were permitted to invest in them.[51] Courts held it beyond the power of a national bank, however, to purchase or underwrite equity stock of corporations or other national banks,[52] or to engage in securities brokerage activities.[53]

The real bills doctrine continued to be the best ''rule of thumb'' for banking safety and soundness. Comptroller of the Currency Knox in 1875 stated, ''a bank is in good condition just in proportion as its business is conducted upon short credits, with its assets so held as to be available on brief notice.'' Comptroller Trenholm in his 1888 annual report stated that national banks constituted ''a body of bankers exclusively devoted to the collection, the safekeeping and employment in temporary loans of the private capital of the country.''[54]

Among the regulations applied to national banks by the National Bank Act was a limit on loans to a single borrower of ten percent of capital.[55] This regulation, which provided a model for similar provisions in state laws, reflected the dangers inherent in the combination of banking and commerce through control of banks by individuals and corporations engaged in nonbanking businesses. The National Monetary Commission remarked on this aspect of the lending limits:

> [I]n many banks a controlling interest is held by a person, firm, or corporation that is actively engaged in other business enterprises. . . . One consequence of the close identification of interests thus brought about between banking and other business enterprises is the probability that loans will be made directly or indirectly to some one borrower to an amount larger than a proper distribution of risks would justify.[56]

IV. Securities Affiliates and the Glass-Steagall Act

A major departure from the separation of commercial banking and investment banking occurred with the development of securities affiliates in the early 20th Century. National banks formed securities affiliates as vehicles to avoid restrictions on their direct securities activities, particularly underwriting. Peach states, ''[t]he simple effect of allowing national banks to organize affiliates . . . was to defeat the purpose of the law in limiting their powers.''[57] By 1930, commercial banks and their affiliates participated in the distribution of 61 percent of all bond issues and had become ''the dominant force in the investment banking field.''[58]

Congressional concern over the commingling of commercial banking and investment banking was first aroused in 1912 by the Pujo Committee hearings focusing on the concentration of money and credit in the so-called ''money trusts.'' The Pujo Committee recommended that national banks be prohibited from underwriting corporate securities.[59]

No Congressional action was taken to limit the securities activities of banks or their affiliates until after the collapse of the stock market in 1929 and the wave of subsequent bank failures in the early 1930s. Congressional hearings on the securities practices of banks disclosed that bank affiliates had underwritten and sold unsound and speculative securities, published deliberately misleading prospectuses, manipulated the price of particular securities, misappropriated corporate opportunities to bank officers, engaged in insider lending practices and unsound transactions with affiliates.[60] Evidence also pointed to cases where banks had made unsound loans to assist their affiliates and to protect the securities underwritten by the affiliates. Confusion by the public as to whether they were dealing with a bank or its securities affiliate and loss of confidence in the banking system were also cited as adverse consequences of the securities affiliate system.

These abuses led to the Glass-Steagall Act prohibiting banks from underwriting or purchasing securities for their own account, with exceptions for government securities and certain investment securities, and banning affiliations and interlocks between member banks and companies primarily or principally engaged in securities activities.[61]

V. Bank Holding Companies

Bank holding companies developed as significant institutions in the banking industry only relatively recently in our history. Group banking, as bank holding companies originally were known, was dependent upon the enactment of state laws authorizing corporations to hold stocks of other companies. The Adam Hannah Company, organized in 1900 in Minnesota, was the first company established to hold stock in banks.[62] Except to the extent holding companies were used to establish securities affiliates of national banks, however, group banking did not become significant until the 1920s.[63]

The early regulatory and Congressional concern over bank holding companies seems not to have been so much with respect to their nonbanking activities—

with the obvious exception of securities activities—as with potential abuses of their subsidiary banks and the opportunities for unlimited geographic expansion and concentration of banking resources.

Beginning with its 1927 Annual Report to Congress, the Federal Reserve Board expressed concern about the use of holding companies to evade state branching laws and the lack of supervision or regular examination by state or federal authorities over such companies.[64] In 1930, a staff sudy by the Federal Reserve Committee on Branch, Group, and Chain Banking concluded that "[t]he chief weakness of the holding company device as an instrument for strengthening the banking structure lies in its manipulative possibilities, and the difficulties of adequate supervision."[65] The study did not indicate bank holding company involvement in nonbanking activities to any substantial extent.

Significant combinations of banking and industrial or manufacturing sectors generally did not occur until later in the 20th Century.[66] Concerns over the development of a conglomerate system thus were not voiced until later and—other than with respect to securities activities—the nonbanking activities of bank holding companies were not restricted until the 1956 Bank Holding Company Act and its 1970 Amendments.[67]

Bank holding companies as a percentage of total commercial banking resources was somewhat modest prior to enactment of the Bank Holding Company Act. In 1955, information provided by the Federal Reserve Board to the House Banking and Currency Committee reported the existence of 114 bank holding companies controlling 452 banks, representing 5.87 of total commercial bank deposits.[68] Forty-six of these companies were subject to regulation under the Bank Holding Company Act of 1956;[69] only five were affected by the divestiture requirements.[70]

Despite the relatively modest growth of bank holding companies,[71] the potential of the holding company device to undermine the historic separation of banking and commerce and result in a concentrated banking system was of such concern to the Congress that the restrictions of the Bank Holding Company Act were deemed necessary.

Bank Holding Company Act

The House Banking and Currency Committee Report on the Bank Holding Company Act of 1956[72] reported that "[e]vidence developed during the hearings has convinced your committee that bank holding companies are not in accord with the very precepts upon which our banking system rests."[73] That Congress intended the Bank Holding Company Act to embody the separation doctrine is clearly stated in the Senate Committee report in 1955:

> In general, the philosophy of this bill is that bank holding companies ought to confine their activities to the management and control of banks and that such activities should be conducted in a manner consistent with the public interest. Your committee believes that bank holding companies ought not to manage or control nonbanking assets having no close relationship to banking.[74]

The Committee report recognized as a basis for this philosophy the quasi-public role of banks as the custodians of the bulk of liquid savings:

> The combination under single control of both banking and nonbanking enterprises [permits] departure from the principle that banking institutions should not engage in business wholly unrelated to banking. Such a combination involves the lending of depositors' money, whereas other types of business enterprise, not connected with banking, do not involve this element of trusteeship.[75]

The Act and its 1970 Amendments aimed at four specific adverse effects that the Congress believed were likely to arise when banking and nonbanking interests are combined: undue concentration of resources, conflicts of interest, unfair competition, and exposure of banks to increased risks, and unsafe and unsound banking practices.

Concentration of Resources

Concentration of resources resulting from corporate ownership of banks was a foremost concern expressed in the Senate Committee report in 1955:

> [B]ecause of the importance of the banking system to the national economy, adequate safeguards should be provided against undue concentration of control of banking activities. The dangers accompanying monopoly in this field are particularly undesirable in view of the significant part played by banking in our present national economy. The extensive use of bank checking accounts in modern commerce exerts an influence on the value of money, which the Constitution empowers the Congress to regulate. Moreover, banking activities are carried on to a large extent by the use of depositors' funds rather than by the use of equity capital subscribed by bank shareholders.[76]

The danger of concentration of resources was again articulated by former President Nixon in 1969 when he submitted legislation to Congress to extend the Bank Holding Company Act to one-bank holding companies:

> Left unchecked, the trend toward the combining of banking and business could lead to the formation of a relatively small number of power centers dominating the American economy. This must not be permitted to happen; it would be bad for banking, bad for business, and bad for borrowers and consumers.
>
> The strength of our economic system is rooted in diversity and free competition; the strength of our banking system depends largely on its independence. Banking must not dominate commerce or be dominated by it.''

Conflicts of Interest

Another goal of the Act was to avoid potential conflicts of interest that undermine the role of banks as impartial granters of credit. The House Committee Report in 1955 expressed concern about preferential treatment of a bank's affiliates:

> If banks were permitted to own nonbanking businesses they would be compelled in many instances to extend credit to such businesses to the detriment of other competitive businesses in the community and possibly also to a degree which would be unsound from a banking viewpoint. A bank should always be at arms' length with its borrowers and such a position could not be maintained were banks permitted to own nonbanking businesses and make credit available to them.'[8]

Unfair Competition

Congress also sought to guard against unfair competition that results when the recipients of preferential credit treatment compete with companies that do not have access to captive banking resources. The potential for unfair competition to arise from the commingling of banking and commerce was cited by the Senate Committee in its report on the 1970 Amendments:

> If a holding company combines a bank with a typical business firm, there is a strong possibility that the bank's credit will be more readily available to the customers of the affiliated business than to customers of other businesses not so affiliated. Since credit has become increasingly essential to merchandising, the business firm that can offer an assured line of credit to finance its sales has a very real competitive advantage over one that cannot. In addition to favoring the business firm's customers, the bank might deny credit to competing firms or grant credit to other borrowers only on condition that they agree to do business with the affiliated firm. This is why . . . if we allow the line between banking and commerce to be eased, we run the risk of cartelizing our economy. . . . Just as we have seen the country's largest banks join the new wave of one-bank holding companies, we could later see the country's business firms clustering about banks in holding company systems in the belief that such affiliation would be advantageous, or perhaps even necessary to their survival.'[9]

Increased Risks and Unsafe and Unsound Practices

The Bank Holding Company Act also reflects a Congressional concern to avoid exposure of banks to the risks of unregulated activities of their parent companies and affiliates and the potential for unsafe and unsound banking practices.

The House Committee Report in 1955 cited several instances where the condition of subsidiary banks had been adversely affected as a result of the activities or practices of their parents and affiliates. The Committee cited cases in which banks had lent heavily to their officers to finance speculation in the stock of their parent holding companies and to the parent companies to finance speculative dealings, and had been compelled to pay unwarranted dividends in the face of operating losses to enable holding companies to maintain their dividend policies.[10] While acknowledging that the Banking Act of 1933 addressed some of these abuses, notably the section 23A limitations on transactions with affiliates, the Committee nevertheless concluded that Bank Holding Company Act regulation was necessary.

The Senate Banking Committee Report in 1955 referred to ''the danger to a bank within a bank holding company controlling nonbanking assets, should the company unduly favor its nonbanking operations by requiring the bank's customers to make use of such nonbanking enterprises as a condition to doing business with the bank.''[11] The Committee similarly noted that

> While it is true that banks within a bank holding company system are subject to Federal or State supervisory authority (and sometimes both), fear has been expressed that, improperly but within the present law, a bank holding company may take undue advantage of one or more banks in its system. This it might do by discounting commercial paper at the bank with a resulting profit to the bank holding company itself but at an unwarranted risk to the bank and its shareholders.[12]

Conclusion

The separation of banking and commerce has been a prevailing regulatory principle applied to banks since colonial times. Early federal and state bank charters granted only limited banking powers and expressly prohibited banks from owning real estate or dealing in goods and merchandise. This policy was continued throughout the 19th Century and into the 20th Century. The separation policy appears to have been dictated by the demand nature of bank obligations, which required a high degree of liquidity of bank investments, as well as by the limited concept of banks as public utilities whose proper role was confined principally to accepting deposits, providing a system of monetary exchange, and making loans.

There are notable periods in our history when the separation of banking and commerce was not as strictly enforced as during other periods. State governments have not applied the policy as strictly as the federal government. Early instances of commingling of banking and commerce tended to occur outside of the banking structure through trust companies and unregulated private banks owned by individuals—the forerunners of today's investment banks—or public improvement companies such as water, canal, and railroad companies that issued notes to raise capital. The experience with these ventures tended to discourage the notion that banking could be safely combined with other business activities. When banks have diverged significantly into nonbanking areas, Congress and the states have reaffirmed the separation of banking and commerce by imposing specific statutory limitations.

Footnotes

1. Miller, *Banking Theories in the United States Before 1960*, 11-14 (1927); Hammond, *Banks and Politics in America from the Revolution to the Civil War* 69 (1957).

2. Hammond, 594.

3. Smith, *An Inquiry Into The Nature and Causes of The Wealth of Nations* (Cannan ed.) 287 (5th ed. 1930); Luckett, *Money and Banking* (3d ed.) 190-91 (1984).

4. Barnett, *State Banking Before the Civil War*, S. Doc. No. 581, 61st Cong., 2d Sess. 183-84, National Monetary Commission (1911).

5. Luckett, 191; Krooss and Blyn, *A History of Financial Intermediaries* 48-51 (1971).

6. *Id.*

7. Shull, "The Separation of Banking and Commerce: Origin, Development, and Implications for Antitrust," *Antitrust Bulletin* 260 (Spring 1983); Hammond, 128-30.

8. *Id.* 259-62. The Act establishing the Bank of England stated the purpose of the prohibition to be "that their Majesties subjects may not be oppressed by the said corporation by their monopolizing or engrossing any sort of goods, wares or merchandise." *Id.* 260.

9. Hammond, 63; Senate Committee on Banking and Currency, "Proceedings in Congress on Bank of North America," *Federal Banking Laws and Reports 1780-1912*, 1-6 (March 15, 1963); Lewis, *History of the Bank of North America* 73 (1882).

10. Report of Secretary of Treasury (Alexander Hamilton) on a National Bank, Dec. 14, 1790, reprinted in *Federal Banking Laws and Reports* 7.

11. Act of February 25, 1791, §7(X), 1 Statutes at Large 191, 1st Cong., 1st Sess. (1791), reprinted in *Federal Banking Laws and Reports* 66, 70. Treble damages were provided for violations of this stricture. *Id.* §8, 71.

12. *Id.* §7(VIII), 69.

13. Report of the Secretary of the Treasury on the Subject of a National Bank (1809), reprinted in Clarke and Hall, *Legislative and Documentary History of the Bank of the United States* 116-120 (1832).

14. Hammond, 142-144.

15. Hammond states, "Legislators hesitated about the kind of conditions under which banking should be permitted but never about the propriety and need of imposing conditions. . . . The issue was between prohibition and state control, with no thought of free enterprise. . . . The impression was general that the exercise of the banking function without express authorization from the sovereign power was improper, if not impracticable." Hammond, 185-86.

16. In early American history, all corporations were held to be of a public character. Redlich, *The Molding of American Banking*, vol. II 60 (1951).

17. Hammond, 27-28; Barnett, George E., *State Banking Before the Civil War*, 143, 147.

18. Barnett, George E., *State Banks and Trust Companies Since the Passage of the National Bank Act* S. Doc. No. 659, 61st Cong., 2d Sess. 33-34, National Monetary Commission (1911).

19. Willis and Bogen, *Investment Banking* 156 (1929).

20. "An act to incorporate the subscribers of the Bank of the United States" §§11-12, reprinted in Krooss and Samuelson, *Documentary History of Banking and Currency in the United States* 460 (1969).

21. Symons, "The Business of Banking: A Historical Perspective," 51 *Geo. Wash. U. L. Rev.* 688 (1983). An exception to this general proscription on nonbanking activities was made for bank investments in Pennsylvania internal improvement companies. *Id.*

22. Hammond, 593. In a few cases, state legislatures granted banking powers to companies whose stated purpose was other than banking, such as the Manhattan Company, chartered by the New York legislature as a water company, and the Wisconsin Marine and Fire Insurance Company, referred to as an "illegal bank." Hammond, 153-55, 171; Golembe, *State Banks and the Economic Development of the West 1830-44* 29-30 (1978); Reubens, "Burr, Hamilton and the Manhattan Company", 72 *Political Science Quarterly*, 578 (1957).

23. Willis and Bogen, 165.

24. James, *The Growth of Chicago Banks* 13 (1938); Green, *Finance and Economic Development in the Old South 1804-1861* 113-14 (1972); Smith, *Economic Aspects of the Second Bank of the United States* 60 (1953). *State Banking Before the Civil War*, 51-53. For example, New Jersey chartered the Morris Canal and Banking Company in 1824; Connecticut in 1832 chartered the Quinebaug Bank as an adjunct to the Boston, Norwich and New London Railroad. In 1835, Michigan conferred banking powers on four railroad companies. The first railroad in Texas was the Texas Railroad, Navigation and Banking Company. Louisiana chartered the New Orleans Gaslight and Banking Company in 1829, the Atchafalaya Railroad and Banking Company in 1834, and in 1836 granted banking powers to the Pontchartrain Railroad. Between 1835 and 1837, South Carolina, Georgia, Mississippi, and Louisiana chartered sixteen combined banking and railroad companies. Klebaner, *Commercial Banking in the United States: A History* 32 (1974).

25. Smith, 60; James, 117-160; Symons & White, *Banking Law* 9 (1984).

26. Reed, "Boom or Bust: Economic Outlook of the 1830's", *Louisiana History*, vol. IV 49 (1963), cited in Green, 34; James, 143, 160; Carosso, *Investment Banking* 3 (1970).

27. *State Banking Before the Civil War*, 52-53.

28. Symons, 689.

29. *Id.*

30. Klebaner, 48.

31. Willis and Bogen, 166-67. Symons and White give a similar assessment: "It was determined that banks should be provided powers that enabled them to assist in the functioning of the economy and in serving enterprise, but stopped them from becoming so involved in enterprise that they could be destroyed by it." Symons and White, 11.

32. *State Banks and Trust Companies*, 12. See generally, Welldon (ed.), *Digest of State Banking Statutes*, National Monetary Commission (1910).

33. Trescott, *Financing American Enterprise* 36 (1963).

34. In 1889, there were 2,097 state banks, 4,215 private banks, and 63 trust companies. By 1900, there were 4,405 state banks, 5,287 private banks, and 492 trust companies; and by 1909, there were 11,292 state banks, 4,407 private banks, and 1,079 trust companies. *State Banks and Trust Companies*, 248, 250, 260.

35. Banking was synonymous with note issue until the mid-19th Century. Redlich, 60-84, 178. Note issuance was considered the most important banking function because it involved the circulation of money. Symons, 9. Deposits did not become significant as a form of money until after the National Bank Act of 1864. Redlich, 66, 175.

36. Trescott, 34-35; Klebaner, 58; Krooss and Blyn, 33-34; *State Banks and Trust Companies*, 213.

37. According to Carosso, in 1902 there were 675 private bankers engaged in investment banking activities. Carosso, *Investment Banking* (1970).

38. *Id.* 85, 89.

39. Krooss and Blyn, 81, 113, 128; *State Banks and Trust Companies*, 10.

40. National banks were not granted trust powers until the Federal Reserve Act of 1913. In addition, reserve requirements for trust companies were less restrictive than for state and national banks. See generally, *State Banks and Trust Companies*, 12-22, 234-40; *Digest of State Banking Statutes*; Krooss and Blyn, 102-103.

41. Despite their liberal charters, there is no evidence suggesting that trust companies were extensively engaged in nonbanking activities other than securities activities and some real estate development and management. Carosso states that trust companies "accepted deposits; made loans; participated extensively in reorganizing railroads and consolidating industrial corporations; acted as trustees, underwriters, and distributors of new securities; and served as the depositories of stocks, bonds, and titles. Frequently they acted as attorneys for individuals and companies. Corporations regularly appointed them as registrars or fiscal and transfer agents. Very often they also owned and managed real estate." Carosso, 98.

42. Perkins, "The Divorce of Commercial and Investment Banking: A History," 88 *Banking Law J.* 483, 487-89 (1971); Treasury Department, *Public Policy Aspects of Bank Securities Activities*, Appendix 3 (1975).

43. Act of June 3, 1864, 13 Stat. 99, §8, reprinted in *Federal Banking Laws and Reports*, 351.

44. See *Weckler v. First National Bank*, 42 Md. 581 (1875); *Mathews v. Skinker*, 62 Mo. 329 (1876); *Logan County Nat'l Bank v. Townsend*, 139 U.S. 67 (1890); and other cases cited in Peach, 39, n.2.

45. Act of June 3, 1864, §28, reprinted in *Federal Banking Laws and Reports*, 359.

46. National banks were not permitted to make loans on real estate until 1913. One-year mortgages on nonfarm property were permitted in 1916; five-year mortgages in 1927; 25-year mortgages in 1964; and 30-year mortgages in 1970.

47. *National Bank v. Matthews*, 98 U.S. 621 (1878).

48. Peach, *The Securities Affiliates of National Banks*, 43–44 (1941); *Lyons v. Lyons Nat'l Bank*, 19 Blatchford 279 (N.Y. 1881).

49. Department of Treasury, *Public Policy Aspects of Bank Securities Activities*, Appendix 2 (1975).

50. *First National Bank v. Bennington*, 16 Blatchford 53 (N.Y. 1879); *Newport National Bank v. Board of Education of Newport*, 70 S.W. 186 (Ky. 1902). The Comptroller of the Currency concurred in this interpretation. Report of the Comptroller of the Currency 8-9 (1909), cited in *Public Policy Aspects of Bank Securities Activities*, Appendix 4.

51. Redlich, 389.

52. See *First Nat'l Bank of Charlotte v. Nat'l Exchange Bank of Baltimore*, 92 U.S. 122, 128 (1875); *Barron v. McKinnon*, 196 F. 933 (Mass. 1912); *Chapman v. First Nat'l Bank*, 285 S. W. 1118 (Tex. 1926); *Cassat v. First Nat'l Bank*, 156 A. 278 (1933); *First Nat'l Bank v. Hawkins*, 174 U.S. 364 (1899); *Shaw v. Nat'l German-American Bank*, 199 U.S. 603, *aff'g* 132 F. 658 (1905); *Metropolitan Trust Co. of New York v. McKinnon*, 172 F. 486 (1909).

53. *Weckler v. First National Bank*, 42 Md. 581 (1875); *Smith v. Philadelphia Nat'l Bank*, 1. Walk. 318 Pa. (1879); *Farmers' and Merchants' Nat'l Bank v. Smith*, 77 F. 129 (1896); *First Nat'l Bank v. Hock*, 89 Penn. St. 324 (1879); and other cases cited in Peach, 46.

54. Redlich, 175; Klebaner, 75, 79.

55. Act of June 3, 1864, §29, reprinted in *Federal Banking Laws and Reports* 359–60.

56. *State Banks and Trust Companies*, 86.

57. Peach, 52. The first security affiliate was established in 1908. The number of banks having securities affiliates increased to 18 in 1922, 62 in 1926, and 180 in 1930. *Id.* 83. In addition, many banks engaged directly in the securities business through their bond departments.

58. Perkins, 495; Peach, 87-93.

59. *Report of the Committee to Investigate the Concentration of Money and Credit*, 62nd Cong., 3d Sess. 151–52, 170 (1913).

60. *Stock Exchange Practices: Hearings Before a Subcommittee of the Senate Committee on Banking and Currency*, 73rd Cong., 2d Sess. (1933).

61. 12 U.S.C. 24 (Seventh), 78, 377, 378.

62. Cartinhour, *Branch, Group, and Chain Banking* 90 (1931).

63. Savage, "A History of the Bank Holding Company Movement, 1900–78," *The Bank Holding Company Movement to 1978: A Compendium* 25 (1978). The legality of bank holding companies was somewhat in doubt prior to 1933. In 1911, the Solicitor General of the United States issued an opinion declaring bank holding companies unlawful. No action was taken to prevent the formation of bank holding companies, however. Opinion of the Solicitor General, Nov. 6, 1911, reprinted in *Stock Exchange Practices*, 2030; see Peach, 144–48.

64. Board of Governors of the Federal Reserve System, *Annual Report* 32 (1927).

65. Board of Governors of the Federal Reserve System, *Branch, Group, and Chain Banking*, Vol. 1, 54 (1930).

66. By 1968, one bank holding companies were engaged in a wide variety of nonbanking activities, including coal mining, farming, electronics, manufacturing, railroads, telephone communications, motion pictures, hospitals, and window cleaning. "The Growth of Unregulated Bank Holding Companies—Problems and Perspectives," House Committee on Banking and Currency (Staff Report) (1969). Most of these companies were formed after 1965. *Congressional Record* 9778–9803 (Oct. 21, 1969) (data compiled for Cong. Patman).

67. The Banking Act of 1933 required corporate owners of member banks to obtain a voting permit from the Board before voting their bank stock and to submit to supervision and examination by the Federal Reserve Board but did not restrict their nonbanking activities. Banking Act of 1933, ch. 89, §19, 48 Stat. 162.

68. H. Rep. No. 609, 84th Cong., 1st Sess. 8 (1955).

69. S. Rep. No. 1095, 84th Cong., 1st Sess. 2 (1955).

70. Savage, 49.

71. Bank holding companies did not grow significantly during the decade following enactment of the 1956 Act. From 1966 through 1970, however, the number of multibank holding companies doubled. Savage, 54. The number of one bank holding companies rose from 117 in 1956 to 550 in 1965 and to approximately 1400 by 1970. Savage, 56. The rapid growth of one bank holding companies has been attributed to, among other things, the usefulness of holding companies in allowing diversification into activities prohibited to banks. *Id.* 57.

72. 12 U.S.C. 1841 *et seq.*

73. H. Rep. No. 609, 84th Cong., 1st Sess. 1–2 (1955).

74. S. Rep. No. 1095, 84th Cong., 1st Sess. 1 (1955).

75. *Id.* 2 (citing Federal Reserve Chairman Martin). The House Banking Committee also articulated the historical separation doctrine. H. Rep. No. 609, 7.

76. S. Rep. No. 1095, 1.

77. Statement of President Richard Nixon of March 24, 1969, reprinted in H. Rep. No. 1747, 91st Cong., 2d Sess. 11 (1970).

78. H. Rep. No. 609, 7 (1955).

79. S. Rep. No. 1084, 91st Cong., 2d Sess. 3 (1970) (quoting Federal Reserve Chairman Martin).

80. H. Rep. No. 609, 4–5 (1955).

81. S. Rep. No. 1095, 5.

82. *Id.* 4.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM
JOHN R. PETTY

Q.1. Do you believe the dollar threshold in S.2372 should be eliminated for failing banks?

A.1. The Association supports the dollar threshold proposed by the regulators. The question of a lower threshold is one best left to Congress and the regulators to decide, and is dependent on the specific situations the bill is meant to address. We have no special insight on the problem situations to permit us to render an independent judgment on the threshold.

Q.2. Do you believe that S.2372 should contain a provision that would give intrastate bidders for any failing bank a "headstart" in the bidding process?

A.2. In my statement submitted for the record, I noted that in 1975 the Association presented several principles that should be useful as a guide in considering inter-state acquisitions in failing situations. One of the principles was that "all possibilities of a rescue within a state should be exhausted before bidders are sought out-of-state." In the case of assisted transactions, the current procedures in the law would be followed, and these appear to have worked very well to protect in-state bidders in light of the fact that only one out-of-state acquisition of a failed bank has occurred in the last four years.

Q.3. What reasons can you cite to support S.2372's limitations on an acquiring institution's expansion into only three standard metropolitan statistical areas?

A.3. We do not favor a limitation on the expansion of an acquiring institution to only three metropolitan statistical areas within the state. We believe that an acquiring institution should be vested with the same expansion rights as institutions within the state to limit the expansion rights of acquiring institutions would in effect discourage participation in the bidding process and place those institutions who do acquire banks at a permanent competitive disadvantage.

Q.4. In testimony before the Committee offered on May 13, 1986, the federal bank regulators argued that this legislation was necessary. Do you believe that state and federal banking authorities currently lack the tools to address the problems confronting energy and farm banks thereby making passage of S.2372 imperative? Would full interstate banking provide a more workable solution to the problems confronting farm and energy lenders by allowing them to expand into economically sound regions rather than the stop-gap solution embodied in S.2372?

A.4. If full inter-state banking were now the law of the land, 2372 would not be needed. We accept the judgment of the regulators that the bill is needed. We do not, however, see S.2372 as a major inter-state banking bill. It is an extremely limited bill allowing the regulators to solicit purchasers on a nationwide basis for certain failing bank holding companies. We do not therefore regard S.2372 as an interstate banking bill.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM JOHN R. PETTY

Q.1. You have argued against imposing any stiffer community re-investment requirements on bank-holding companies that acquire banks under this emergency authority. You say there is no reason why a holding company owned bank will be any less responsive to meeting consumer and local credit needs.

However, a recent study in the March/April edition of the New England Economic Review shows that there are significant differences in the way holding company banks allocate their loans compared to independent banks. The study shows that holding company controlled banks loan about 20 percent less to agriculture, to real estate, and to state and local governments compared to independently owned banks.

This being the case, why shouldn't the Congress impose stiffer community re-investment requirements if it wants to protect these sources of credit for borrowers who don't have ready access to national credit markets?

A.1. Studies such as you cite are not as unambiguous as your question suggests regarding the article in the March/April Economic Review published by the Federal Reserve Bank of Boston. The Federal Reserve Board reported to Congress in 1978 ("the Bank Holding Company Movement to 1978: A Compendium") that (p. 277):

> Performance studies have generally shown, for example, that banks acquired by holding companies often provide more credit to the local community than do non-affiliated banks. Moreover, affiliated banks pay higher interest on time and savings deposits than do nonaffiliated banks.

It is my impression that this general conclusion has held up through today, notwithstanding findings such as you report. One explanation for a change in the mix of loans at holding company banks is that management decides to concentrate agricultural or real estate lending on the books of one of the company's subsidiary banks, thus creating variances in the portfolios of each of the company's banks. To determine the extent of lending by holding companies, it is necessary to look at the entity as a whole. I am confident that when this is done, the overwhelming majority of holding company banks will show higher loan-to-deposit ratios than independent banks.

Q.2. One of the things that worries me about unrestricted nation-wide banking is the possibility that more and more banking resources will be concentrated in the hands of a few giant bank holding companies. On the other hand, your organization has argued that this kind of super-concentration is highly unlikely.

If you are correct, would you have any objection to imposing concentration limits on inter-state bank acquisitions? That is, once a bank holding company controlled a sizeable percentage of total banking assets, it would not be permitted to acquire additional banks across state lines regardless of whether the bank was failing or not.

A.2. We do not believe the imposition of increased limits on the concentration of banking resources is appropriate. The banking industry already is subject to the concentration limitations contained in existing laws not applicable to other industries. We see no justification for singling out the banking industry for even more restrictive treatment in this regard. Moreover, other factors argue against imposition of concentration limitations. That is, the industry is very unconcentrated at the present time - even when compared to other segments of the financial services industry. Also, unlike entry into other industries, barriers to entry into the banking industry are relatively low. Consequently, there always will be a place for new entrants into the banking markets. Finally, experience has shown that smaller, independent banks can effectively compete against large banks. Golembe Associates, The Regulation of Bank Size: Historical Foundations and Future Prospects (1984). Accordingly, we do not believe it is proper to impose further concentration of resources limitations on bank holding companies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
JOHN R. PETTY

Q.1. What significant cost savings, if any, do you see accruing to the FDIC as a result of the proposed expansion of the regulators' authority?

A.1. It stands to reason that the larger the bidding universe the more competitive will be the bidding process. Moreover, the more competitive the bidding process, the more likely that significant cost savings will be realized by the FDIC. These factors argue for cost savings, but how significant they will be is impossible to estimate.

Q.2. I would like to get the reaction of the panel to the suggestion that any emergency acquisition under the expanded authority should be permitted only if the state banking regulator in the failing institution's home state does not object to the acquisition.

A.2. We believe the state regulators should have a role in the resolution of failed and failing bank situations. S.2372 provides a role for regulators in both assisted and unassisted transactions. In the latter case, the state regulator does have authority approximating a veto, as I noted in my statement. In assisted transactions, the authority of the state regulator is somewhat less. We believe the reduced role for the state regulator in assisted transactions is appropriate because, in the final analysis, it is the FDIC that will be paying the bill and the federal regulators therefore should have the final word.

Q.3. A number of you have criticized the regulators' bill for using imprecise and imperfect criteria to establish what is and what is not a bank "in danger of closing." What recommendations do any of you have for a more precise definition?

A.3. We support the bill as introduced with respect to the test on when a bank is "in danger of closing." We, therefore, do not recommend any changes to the present language.

Q.4. To what extent, if any, do you believe that some form of preferential treatment should be given to an intrastate or intraregion bank?

A.4. In answer to a question by Sen. D'Amato, I noted that my statement listed several principles we suggested to Congress in 1975, including one that "all possibilities of a rescue within a state be exhausted before bidders were sought out-of-state." In light of this statement, and our long-standing encuragement of regional banking statutes, we would not object to an amendment requiring FDIC to give priority to bidders located in contiguous states and then to bidders located in states in the same regional compact, before soliciting bids nationwide.

Q.5. To what extent do you believe it might be counterproductive to signal the demise of a bank by formally classifying it as failing and openly seeking bidders, as might be the case under regulators' bill?

A.5. The bidding procedure usually used by the Regulators in the case of institutions that are going to be closed is highly confidential and secretive in nature. We assume that a similar procedure would be used in the case of failing institutions. In those instances where the public may become aware of what is happening, we believe that confidence in the Federal deposit insurance fund would allay any undue concern. Such was the case in New York State with respect to several of the failing savings banks and in the Continental Illinois situation.

Q.6. In the past, the bank regulatory agencies have been able to handle a number of bank problems and failures without the need for the type of legislation we are considering today. A number of instances come readily to mind: Franklin National Bank and the U.S. National Bank; the First Pennsylvania Bank; and Continental Illinois to name a few.

Do you believe that the same imaginative remedies that were used in those instances could be used in future instances without additional legislation?

A.6. The problem with relying on past remedies to solve current and future situations is that the circumstances are not the same. First, because of energy and farm problems, we have a much larger number of institutions thus lessening the Regulators' options. The Regulators have not been bashful in the past with respect to handling problem bank situations. We take it that the bills currently pending before the Congress were submitted by the Regulators because they believe that they need the additional statutory flexibility. Because of the restrictions of current law, if the Regulators are required to use their current authority, much more of the insurance fund would have to be obligated. The issue thus narrows to a determination of whether we want the Regulators to use expensive imaginative measures or less expensive additional statutory options. We think the answer is clear.

Q.7. In the past when we have had actual, as opposed to potential banking crises, states have acted expeditiously to address the situation. Given the fact that states have the capacity and the responsibility to act when necessary, what do you see as the compelling reason for federal involvement and preemption at this time?

A.7. While some of the States have reacted or are reacting to the current situation, not all of the states involved have done so. On the other hand, the Association views the current situation as requiring a national policy as well. The Federal deposit insurance fund is a fund established by Federal law. As such, it is the primary responsibility of the Congress to insure that the Federal Regulators have the necessary statutory flexibility to safeguard the fund and protect the banking [illegible] Those states that have enacted legislation to address the [illegible] should be commended. Their actions, however, [illegible] for Congressional action at the national level.

Q.8. Any [illegible] the interest of a state in fashioning a timely and suitable remedy to a problem situation at least as great as that of the FDIC, if not more so?

A.8. No one underestimates the important role that a state should play in resolving the current problem situation in banking. The original Garn-St Germain interstate acquisition authority and the pending legislation were both crafted with that notion in mind. In the final analysis, however it is going to be the FDIC that is going to have to pay the bill. While any solution to the current problem should consider the interests of the states, we should not forget that ultimately it is going to be the Federal deposit insurance fund that is going to pay the bill.

Q.9. How would each of you propose dealing with the stockholders of a bank that is merged with federal assistance because it is "in danger of closing?"

A.9. The stockholders in failing bank situations should be dealt with in the same manner as failed bank situations. They should have their investment put at risk of loss.

Q.10. The regulators' proposed bill, as I understand it, would permit the sale of an entire holding company if a certain percentage of its assets are in the failing category. I would think, however, that there would be a certain attraction to selling only those subsidiaries considered failing, along perhaps with other subsidiaries with capital deficiencies that have arisen in a normal course. I would like to get your reaction to the regulators' proposal which would allow the sale of the entire holding company?

A.10. We think that the Regulators should be given maximum flexibility in dealing with holding company failures. Thus, they should be able to sell either all or part of the holding company in accordance with the facts of each situation.

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RANDOLF H. AIRES
VICE PRESIDENT

202 737 4900

June 30, 1986

The Honorable Jake Garn
United States Senate
Washington, D.C. 20510

Dear Senator Garn:

Thank you for the opportunity to respond for the record to the submission by the Independent Bankers Association regarding the regulation of "nonbank banks."

The attached statement by Sears, Roebuck and Co. addresses each of the arguments submitted by that organization and explains how each of the arguments is either untrue, a half truth or fails to recognize appropriate factors in the regulation of this class of depository institutions.

For example, while the Independent Bankers submission sets out to "demonstrate that nonbank banks are half-regulated entities" it ignores the regulations to which the bank itself is subject and focuses instead on the fact that the parent company — in our case, Sears — is not regulated by the Federal Reserve Board.

The attached paper points out both the regulations to which consumer banks are currently subject as well as those areas that Sears believes Congress may wish to legislate in terms of further protections along the lines suggested in Sears "family bank proposal."

Sincerely,

Randolf H. Aires

Enclosure: The Regulation of
Consumer Banks

ALLSTATE INSURANCE GROUP · COLDWELL BANKER REAL ESTATE GROUP · DEAN WITTER FINANCIAL SERVICES GROUP
SEARS MERCHANDISE GROUP · SEARS WORLD TRADE

The Regulation of Consumer Banks

In its response to the Senate Banking Committee dated June 4, 1986, the Independent Bankers Association of America (the "IBAA") attempted to show that consumer banks -- *i.e.*, Federal Deposit Insurance Corporation ("FDIC") insured banks that accept demand deposits but do not engage in the business of making commercial loans -- are "half-regulated entities." Instead of supporting that patently incorrect statement, however, the IBAA devoted its entire paper *not* to that issue but rather to proving the uncontested proposition that companies that own consumer banks are not regulated as bank holding companies under the Bank Holding Company Act.

We agree with the IBAA that companies that are not bank holding companies are not subject to the regulations to which bank holding companies are subject. This truism does not, however, alter the fact that *consumer banks are no less regulated than are other banks*. An analysis of the IBAA's arguments confirms this.

This paper will address many of the arguments made by the IBAA and will be limited to arguments which deal specifically with Sears, Roebuck and Co. or which deal generally with the ownership of consumer banks by large corporations like Sears.

Affiliate Transactions

The most important point regarding affiliate transactions is unfortunately obscured in the IBAA's discussion; it should be stated at the outset clearly and without qualification: FDIC-insured consumer banks, like all other FDIC-insured banks (including those owned by bank holding companies) are subject to all of the strictures of Section 23A of the Federal Reserve Act (12 U.S.C. §371c) relating to transactions with affiliates.[1]

This being the case, the IBAA's sole argument is that the policing of Section 23A is hampered by the absence of Federal Reserve examination of the affiliates of consumer banks.[2] It is extremely unlikely that such an examination could uncover Section 23A violations which would not be discoverable from an examination of the banks themselves since by definition a bank must be a party to a transaction covered by Section 23A. In fact, a number of equally important statutes involving transactions between banks and other parties are regulated by federal law and are adequately policed despite the fact that the other party is not subject to Federal Reserve examination. Two examples are 12 U.S.C. §84, which limits the aggregate loans by a national bank to one borrower, and Sections 22(g) and (h) of the Federal Reserve Act (12 U.S.C. §§375a and 375b), implemented by Federal Reserve Regulation O, which restrict loans to insiders. To the best of our knowledge, neither the IBAA nor anyone else has ever suggested that enforcement of the per borrower lending limits or Regulation O has been hampered because the federal banking authorities lack examination authority over the borrowers involved, or that, based on these laws, all such borrowers should be subject to such examination. The argument is equally uncompelling with respect to Section 23A.

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[1] Contrary to the IBAA's view, there is nothing incorrect in the FDIC's interpreting Section 18(j) of the Federal Deposit Insurance Act as subjecting all FDIC-insured consumer banks to Section 23A. The statute is unambiguous in this respect. As to the IBAA's rhetorical flourish that the FDIC would insure deposits at a McDonald's restaurant if the restaurant had a national or state bank charter, it hardly needs to be pointed out that under neither the National Bank Act nor any state law dealing with bank charters of which we are aware would it be lawful for a bank to engage in the fast-food business. If it were, we have no doubt that the FDIC would promptly interpose regulations, as they have already done regarding bank securities activities (12 C.F.R. §337.4) and have proposed to do regarding bank insurance and real estate activities (50 Fed. Reg. 23,963 (1985)).

[2] The IBAA states, without citing any legislative history or other supporting materials, that "one of the main reasons" for the enactment of the Bank Holding Company Act was to give the Federal Reserve Board explicit authority to supervise the holding company side of transactions between banks and their owners. This was perhaps considered in enacting the Act, but it was hardly a "main reason," and various Congressional summaries of the purposes of the Act fail to list it as being among the Act's purposes. *See*, *e.g.*, H.R. Rep. No. 609, 84th Cong., 1st Sess. 2-6 (1955); S. Rep. No. 1179, 89th Cong., 2d Sess., *reprinted in* 1966 U.S. Code Cong. & Ad. News 2385, 2386; Staff of House Comm. on Banking and Currency, 91st Cong., 1st Sess., *The Growth of Unregistered Bank Holding Companies — Problems and Prospects* 1, *reprinted in* Carter H. Golembe Associates, Inc., *The Bank Holding Company Act Amendments of 1970* 15, 16 (1971).

The other "improper affiliate transactions" listed by the IBAA may be located by an examination of a consumer bank itself.

Examinations

The IBAA argues that the FDIC is unable to "accurately gauge the health" of a consumer bank if it cannot examine the bank's owner or rely on Federal Reserve examination reports. The reasoning behind this argument is puzzling. There is no better way to gauge the health of a consumer bank than by rigorously examining that bank directly; indeed, this was the sole available basis for the FDIC's evaluation of banks before the Bank Holding Company Act of 1956, and it remains the sole such basis for the many banks that are not owned by bank holding companies, as is the case for a substantial number of the banks which make up the IBAA's membership.

The IBAA's argument actually stands on its head the purpose of Federal Reserve examination of bank holding companies. The paramount purpose of such examinations is to monitor compliance with laws that apply to bank holding companies particularly, of course, the Bank Holding Company Act. In fact, it is the Federal Reserve Board that is statutorily mandated to use, as far as possible, the reports of the Office of the Comptroller of the Currency, the FDIC or the appropriate state supervisory authorities for the purposes of its examinations. 12 U.S.C. §1844(c). The statutory scheme thus indicates that it is the Federal Reserve Board in its supervision of bank holding companies that depends on FDIC and state supervisory bank examinations, rather than vice versa.

In addition, if financial information concerning the parent corporation of a consumer bank is actually required, it can be readily obtained, in the case of Sears and other publicly owned corporations, simply by examining the corporations' periodic filings under the Securities Exchange Act of 1934. Contrary to the position of the IBAA, these filings by Sears, and other publicly owned corporations which own consumer banks, allow regulatory authorities "to get a complete snapshot of the company's operations at a single moment in time."

Nonbank Activities of Affiliates

Sears has elsewhere addressed the inaccuracy of the often repeated statement that there is a longstanding policy of separating banks from general commerce. (*See* Brief of Sears, Roebuck and Co., *et al.*, as amicus curiae, filed with the United States Supreme Court in support of respondents in Board of Governors of the Federal Reserve System v. Dimension Financial Corporation, et al., September 11, 1985.) As Sears has pointed out, the extension of the coverage of the Bank Holding Company Act in 1970 to one-bank holding companies was accompanied by a broadening of the activities in which bank holding companies could engage and by the creation of the exception for consumer banks. The concentration of power of commercial credit was clearly the main concern evidenced by the 1970 amendments and not consumer lending. A bank which does not engage in commercial lending, such as a consumer bank, does not present the risks Congress feared might arise when commercial banks were affiliated with nonbanking companies.[3]

The litigation referred to by the IBAA involving Sears Savings Bank in California does not support the contention that "unhealthy tie-ins are beginning to appear between nonbank banks and their owners." First, the entity involved, Sears Savings Bank, is a savings and loan and not a bank, is a Federal Savings and Loan Insurance Corporation ("FSLIC") insured institution, and while its ownership by Sears is consequently not subject to the Bank Holding Company Act, it is regulated by the Savings and Loan Holding Company Amendments of 1967 and is subject to the full regulatory strictures -- including affiliate transactions regulations -- that those amendments established. Second, the litigation involved demonstrates that legal redress does exist under existing law if abuses of the type alleged ever do occur. Third, and of paramount importance, this litigation is entirely without merit, as is explained in the statement that Sears has prepared and which is attached to this paper as Exhibit I.

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[3] It is precisely because the presumption of the Bank Holding Company Act is against commercial banks being affiliated with nonbanking companies that bank holding companies must demonstrate public benefits outweighing possible adverse effects in order to obtain approval to engage in nonbanking activities. The absence of similar concerns regarding consumer banks accounts for their affiliates' activities not being subject to the same hurdle.

The supposed potential abuses of consumer banks, which lack the potentially coercive power of commercial banks (consumer credit being a highly competitive, widely available and largely fungible service), have yet to be demonstrated or persuasively shown to be a serious threat. On the contrary, consumer banks have shown the capacity for innovative consumer services and heightened competition in the financial services market place and bringing enhanced capital to the banking system. Nevertheless, Sears is not unsympathetic to strengthening regulatory tools and would support legislation to make the anti-tie-in provisions of federal law that apply to bank holding companies equally applicable to companies that own consumer banks.

Community Reinvestment Act

As is the case of every other statute pertaining to banks that the IBAA has cited, consumer banks are as fully regulated by the Community Reinvestment Act as any other bank.

The IBAA nonetheless argues that the fact that consumer banks do not make commercial loans impairs their ability to comply with the Community Reinvestment Act. This argument is fallacious. The Community Reinvestment Act does not require commercial banks to make every type of loan available and thus consumer banks are not under that obligation. Instead, the genius of the Act is the flexibility that it gives banks to approach the Act's objectives, that is, meeting the credit needs of their communities, in the ways that they judge most appropriate to their individual circumstances, rather than imposing on all banks a rigid and uniform set of compliance requirements. Nothing in the language or policy of the Act suggests that commercial lending is mandatory for compliance; in fact, the inclusion in the Act of FSLIC-insured thrift institutions, most of which had little, if any, commercial lending authority in 1977 when the Act was enacted, demonstrates that the opposite is true.

Management Interlocks

The IBAA's statement that the owners of consumer banks are free to serve as management of their banking competitors happens to be untrue insofar as it applies to Sears. As the owner of a California-chartered savings and loan association that is FSLIC-insured, Sears is a savings and loan holding company subject to the prohibitions on management interlocks contained in the Depository Institutions Management Interlock Act.

Bank Merger Act

The IBAA argues that mergers or acquisitions involving consumer banks and their corporate parents "are not generally subject to the same degree of antitrust scrutiny that mergers involving full-service banks and bank holding companies receive." The IBAA appears to have confused the statutory framework governing bank mergers and acquisitions. There is absolutely no difference between the application of the Bank Merger Act to a transaction involving a consumer bank and its application to a transaction involving any other bank. Any transaction involving a commercial bank that requires regulatory approval under the Bank Merger Act requires exactly the same regulatory approval if a consumer bank is involved.

In the case of an acquisition of a bank in a transaction that is not subject to the Bank Merger Act, the statute that applies to the transaction will of course differ depending upon the type of bank involved. If the bank being acquired is a consumer bank (or if the acquiring party does not come within the definition of a "company" under the Bank Holding Company Act), then the transaction is governed by the Change in Bank Control Act. Alternatively, if the bank being acquired comes within the definition of a "bank" under the Bank Holding Company Act, and the acquiring party comes within the definition of a "company" under the Bank Holding Company Act, then the transaction is governed by the Bank Holding Company Act. While there are many differences between those statutes, one area in which there is not a significant difference between them is the "antitrust scrutiny" that each brings to bear on bank acquisitions to which it applies. Both the Change in Bank Control Act and the Bank Holding Company Act require advance notification of a proposed transaction to be provided to the appropriate bank supervisory authority,[4] and both statutes require the identical antitrust standards to be applied to the proposed transaction. While the Bank Holding Company Act imposes the additional requirement that the Federal Reserve Board immediately notify the Attorney General of any approval by it under the Act, the Attorney General would also receive notification of a proposed transaction pursuant to the Change in Bank Control Act if the acquiring corporation and the bank which it seeks to acquire are each of the requisite size for the Hart-Scott-Rodino Antitrust Improvements Act to apply. Under the Hart-Scott-Rodino Act, both corporations would have to file advance notification of the transaction with the Federal Trade Commission ("FTC") and the Assistant Attorney General in charge of the Antitrust Division of the Justice Department ("Assistant Attorney General"). Although transactions which are subject to the Change in Bank Control Act are exempted from the requirements of the Hart-Scott-Rodino Act by an FTC premerger notification rule, 16 C.F.R. §802.8(b), under the FTC rule copies of all information and documentary materials filed with the appropriate federal banking agency pursuant to the Change in Bank Control Act would have to be filed contemporaneously with the FTC and the Assistant Attorney General at least thirty days prior to the consummation of the proposed transaction.

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[4] Under the Bank Holding Company Act, of course, an application will always be filed with the Federal Reserve Board as well.

The IBAA also questions the antitrust scrutiny that will apply to the commencement of other financial services by the corporate parent of a consumer bank. In fact, as stated above, under the Hart-Scott-Rodino Act if the parent company is a large company, such as Sears, and it seeks to acquire any company (whether a financial services company or not) that is also of the requisite size, then both corporations must file advance notification of the proposed transaction with the FTC and the Assistant Attorney General. Both the FTC and the Antitrust Division of the Justice Department then have the opportunity to review the proposed transaction on antitrust grounds.

In short, consumer banks and their owners are subject to substantial antitrust supervision under a variety of federal statutes.

Glass-Steagall Act

Once again, the IBAA in evaluating the applicability of the Glass-Steagall Act, has muddied the basic legal facts. The Glass-Steagall Act, which predates the Bank Holding Company Act by 23 years, applies identically to consumer banks and to commercial banks. The limited application of the Act to nonmember state banks or to affiliates not "principally engaged" in securities activities has nothing to do with the consumer bank issue. In fact, with no consumer bank involvement, full-service banks have availed themselves of the special treatment for nonmember state banks, giving rise to the FDIC's recent regulations in this area (12 C.F.R. §337.4), and regulated bank holding companies (*e.g.*, Citicorp in a pending application before the Federal Reserve Board under Section 4(c)(8) of the Bank Holding Company Act) are attempting to take advantage of the "principally engaged" limitation.

Payments System

The IBAA's statement that consumer banks are not fully subject to the Federal Reserve Board's supervision of the payments system is inaccurate and untrue. The use by consumer banks of the payments system is equally subject to supervision by the Federal Reserve Board as is the use of the payments system by any other bank, and the Federal Reserve Board has the same ability to monitor the use of the payments system and to detect abuses even though a consumer bank is not affiliated with a bank holding company. Indeed, one of the IBAA's stated concerns is the incidence of overdrafts by the consumer bank on behalf of its parent. However, an overdraft of that kind would be a commercial loan by the consumer bank in violation of its charter. The sanction is the very harshest for a company such as Sears: its consumer banks would become a "bank" for purposes of the Bank Holding Company Act and since the activities restrictions placed on bank holding companies do not encompass general merchandise retailing, Sears would be forced to divest of its bank. The severity of that sanction is unparalleled for commercial banks.

Enforcement Authority

The IBAA states that it is unclear whether bank regulatory authorities may take enforcement action against the owners of consumer banks. If this is the case, in the limited instances where this authority would be needed Sears has supported several bills that would give the Federal Reserve Board limited regulatory authority over the parent corporations of consumer banks. These bills include H.R. 3876, sponsored by Congressman Lundine, the Consumer Bank Act of 1985, and H.R. 4870, the Consumer Products and Financial Services Equity Act of 1986, sponsored by Congressman Dreier.

Right to Financial Privacy Act

The IBAA states that it is unclear whether consumer banks are governed by the Right to Financial Privacy Act. The IBAA further states that even if the statute does apply to consumer banks, "it is clear that the confidentiality of such records does not extend to transactions between a [consumer] bank and its affiliates."

Consumer banks clearly are covered by the Act; it applies to "financial institutions," defined as any office of a bank, savings bank, credit card issuer, industrial loan company, trust company, savings and loan, building and loan, or homestead association, credit union, or consumer finance institution. (12 U.S.C. 3401(1)). Nothing in the Act implies that it would not apply to a consumer bank, and except for the IBAA, no one has ever to our knowledge suggested otherwise. Moreover, the IBAA is clouding the issue by stating that the Right to Financial Privacy Act does not extend to "transactions" between a consumer bank and its affiliates. Of course this is true. The Act regulates only disclosures of financial information by any covered institution to federal agencies and it does not apply to "transactions" (by which we assume the IBAA means disclosures of information) between a bank and its affiliates even if the owner of the bank is a fully regulated bank holding company. The fact that a consumer bank may be involved has no bearing on this issue.

* * *

In conclusion, there is nothing to support the IBAA's proposition that consumer banks are "half-regulated entities." In lieu of law and fact, the IBAA has deliberately focused on the limited regulation of consumer banks' parent companies rather than the regulation of consumer banks themselves. Consumer banks are fully regulated financial institutions and as such pose no greater risk to the financial system than do the banks represented by the IBAA.

Sears, Roebuck and Co.

June 30, 1986

EXHIBIT I

PAPAGAYO ENTERPRISES, ET. AL. ("HUNTS") vs. SEARS SAVINGS BANKS, ET. AL. ("SSB")

In Papagayo Enterprises vs. Sears Savings Bank, the plaintiff, Larry Hunts, alleges that SSB coerced him into accepting Sears appliances and the services of Coldwell Banker for a California condominium project Hunts was developing for SSB. Opponents of the ownership of consumer banks by retailers and other commercial companies argue that this case illustrates the kind of improper tying arrangements that can result from such affiliations.

This case illustrates no such thing. Hunts' allegations are untrue. As the evidence in the case will demonstrate, Hunts freely chose the Sears appliances and Coldwell Banker real estate services.

HISTORY OF THE TRANSACTION

The case involves a condominium project called Windsong Cove in Carlsbad, California. Hunts, an experienced architect and real estate developer, originally acquired the land with a loan from the Bank of California. He developed one phase of the project, and then was stopped from further development by the California Coastal Commission. Because of that problem, Hunts defaulted on his land loan and filed bankruptcy proceedings. During the bankruptcy, the Coastal Commission approved development on additional parcels of the property, but the Bank of California obtained permission from the bankruptcy court to proceed with foreclosure.

At this point, in the Spring of 1981, Hunts approached SSB to invest in the project. In June, 1981, Hunts and SSB agreed to the following terms: SSB acquired from Hunts the title to the portion of the land approved for further development and paid off Hunts' loan from the Bank of California. SSB and Hunts entered into a development agreement for 161 units, under which Hunts would act as developer for the land owned by SSB, for which Hunts was to receive a monthly fee and also a 20% share of profits, if any. SSB would provide the funds for development and retained the right to approve all project contracts over $10,000.

The agreement also included provisions dealing with a parcel of the land not then approved by the Coastal Commission for development, the title to which was at first retained by Hunts. Later, in accordance with the contract, SSB also purchased that parcel from Hunts and paid him $1.2 million.

Hunts has stated in the press that these terms were imposed on him by SSB two days before the Bank of California foreclosure date, giving him no choice. He says that at that time SSB surprised him with a development agreement instead of a joint venture agreement. These claims are untrue. Hunts and his counsel had drafts of the terms proposed by SSB weeks before the foreclosure date.

During the course of development, and well after the development agreement was signed, Hunts obtained bids for appliances for the project. Sears submitted a bid for its Kenmore appliances that matched the lowest bid and Hunts accepted the Sears bid. The Sears appliances were installed in most of the units.

Hunts also engaged real estate sales agents for the project. Initially, he hired George Charles, LTD., who was terminated because of inadequate staff to handle the sales. Hunts then engaged Coldwell Banker, who was also later terminated because of slow sales. Hunts finally hired Developers Marketing Associates, who remained with the project.

SSB became dissatisfied with Hunts' performance as developer and terminated the development agreement in October, 1984. At this time Hunts was 21 months behind schedule and 23% over budget.

THE LAWSUIT

In October, 1984, shortly after termination of the development agreement, Hunts filed a suit against SSB, Sears and Coldwell Banker in Superior Court in San Diego, demanding $100 million in actual and punitive damages. The suit contains two basic types of counts. Breach of contract counts allege that SSB wrongfully terminated the development agreement and was itself in breach of it. Antitrust counts allege violations of California's Cartwright Act, a state version of the Federal Sherman Act, and claim that the defendants conspired in a tying arrangement by coercing Hunts into accepting the Sears appliances and Coldwell Banker services.

In 1986, the complaint was amended to include an alleged violation of the Federal Racketeer Influenced and Corrupt Organizations Act (RICO), which asserts criminal antitrust violations as a basis for civil damages.

NO BANKING POLICY IMPLICATIONS

The attempts by opponents of consumer bank ownership by commercial firms to use this case as support for their position have no foundation. Despite plaintiff's spurious allegations of tying, the case is essentially one involving nothing more than a commercial dispute instigated by a highly sophisticated real estate developer and architect.

As noted, the allegations of tying are false and have no support in the objective evidence. With regard to the Sears appliances, for example, not only did Sears match the lowest bidder sought by Hunts but Hunts himself stated in correspondence that Kenmore appliances delivered both higher quality and cost savings to the project. As to the real estate sales agent services, Coldwell Banker was chosen by Hunts and then later terminated by him without objection from SSB.

Moreover, this is not the kind of case that suggests any potential abuse of consumers through tying arrangements. SSB was the legal owner of the project, provided all the development funds, was entitled to 80% of the profits, and had a legal right to approve contracts proposed by the developer. Accordingly, there would be nothing improper in SSB's deciding upon such things as appliances and real estate services, had it chosen to do so. The facts, therefore, contrast with cases where unsophisticated consumers might be forced to accept other products as a condition of obtaining credit.

Finally, in circumstances where attempts are made to coerce consumers when they apply for credit, legal remedies are available under existing statutes. Federal laws applicable to FSLIC insured institutions and many banks declare such practices illegal and regulatory penalties and other remedies can be applied. In addition, state and Federal antitrust laws can be used to combat such practices, under appropriate circumstances. In fact, the Papagayo case itself is an example of a plaintiff who seeks to employ an antitrust law remedy.

June, 1986

Frank J. Duda, Jr.
General Counsel
Sears Savings Bank

David Shute
General Counsel
Sears Consumer Financial Corporation